STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

South Beloit Water, Gas and Electric Company	:	**03-0676**
	:	
Proposed general increase in natural gas rates.	:	
	:	**(Cons.)**
South Beloit Water, Gas and Electric Company	:	
	:	**03-0677**
Proposed general increase in water rates.	:	

PROPOSED ORDER

DATED: August 25, 2004

TABLE OF CONTENTS

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South Beloit Water, Gas and Electric Company	:	**03-0676**
	:	
Proposed general increase in natural gas rates.	:	
	:	**(Cons.)**
South Beloit Water, Gas and Electric Company	:	
	:	**03-0677**
Proposed general increase in water rates.	:	

PROPOSED ORDER

By the Commission:

I. PROCEDURAL HISTORY

On October 10, 2003 South Beloit Water, Gas and Electric Company ("SBWGE" or the "Company") filed, with the Illinois Commerce Commission ("Commission"), tariff sheets in which it proposed a general increase in natural gas rates to be effective January 1, 2004. The revised tariff sheets submitted for natural gas service are Tariff No. 11; Original Sheets No. 1, Original Sheets Nos. 2, 2.1, Original Sheets No. 3, Original Sheets Nos. 4, 4.1, Original Sheets Nos. 5, 5.1, 5.2, 5.3, 5.4, 5.5, Original Sheets Nos. 6, 6.1, 6.2, 6.3, 6.4, 6.5, 6.6, 6.7, Original Sheets Nos. 7, 7.1, Original Sheets Nos. 8, 8.1, 8.2, Original Sheets Nos. 9, 9.1, 9.2, 9.3, Original Sheets Nos. 10, 10.1, 10.2, 10.3, Original Sheets Nos. 11, 11.1, Original Sheets Nos. 12-13, Original Sheets Nos. 14, 14.1, 14.2, 14.3, 14.4, 14.5, 14.6, 14.7, 14.8, Original Sheets Nos. 15, 15.1, 15.2, 15.3, 15.4, 15.5, 15.6, 15.7, 15.8.

On October 15, 2003 SBWGE filed tariff sheets in which it proposed a general increase in its water rates to be effective January 1, 2004. The revised tariff sheets submitted for water service are Tariff No. 8, Original Sheets Nos. 1-11, Original Sheets Nos. 12, 12.1, Ill. C.C. No. 7 Revised Sheet No. 6, Canceling 2nd Revised Sheet No. 6, Ill.C.C. No. 7, First Revised Information Sheet No. 1, Ill.C.C. No. 7, First Revised Information Sheet Nos. 30-33.

Hereafter, the proposed natural gas and water tariff sheets identified above are jointly referred to as the "Filed Rate Schedule Sheets" or "Proposed Tariffs." The Proposed Tariffs specified an effective date of January 1, 2004. In a Suspension Order dated November 5, 2003, the Commission suspended the Proposed Tariffs for a period of 105 days beginning on January 1, 2004, to and including April 14, 2004. The gas rate case was assigned Docket No. 03-0676 and the water rate case was assigned Docket No. 03-0677. On April 7, 2004, Commission resuspended the Filed Rate Schedule Sheets to and including October 14, 2004.

Pursuant to due notice, a pre-hearing conference was held in this matter before a duly authorized Administrative Law Judge of the Commission at its offices in Springfield, Illinois on November 25, 2003. SBWGE made a motion to consolidate Docket Nos. 03-0676 and 03-0677. There were no objections and the motion to consolidate was granted.

On December 4, 2003, SBWGE filed a request for rehearing on the suspension orders in both Docket Nos. 03-0676 and 03-0677. Staff opposed SBWGE's request for rehearing. On December 17, 2003, the Commission denied SBWGE's request for rehearing.

In accordance with the requirements of Section 9-201(a) of the Public Utilities Act ("Act"), 220 ILCS 5/1-101 et seq., and 83 Ill. Adm. Code 255, notices of SBWGE's filings with the Commission were published in newspapers of general circulation throughout SBWGE's gas and water service territories. SBWGE indicates further that a copy of a public notice was posted and a copy of the filing with the Commission was made available for public inspection at its Rockton, Illinois office.

An evidentiary hearing was held at the Commission's Springfield offices on May 19, 2004. Testimony and exhibits offered by SBWGE and Staff were admitted into the record. The following witnesses testified on behalf of SBWGE: Douglass K. Carlson adopting the testimony of Jill Osterholz, Sonya M. Kessinger, Lawrence J. White, Martin W. Seitz, and Enrique Bacalao. The following witnesses testified on behalf of the Staff: Bonita A. Pearce, Burma C. Jones, Thomas Q. Smith, Janis Freetly, Cheri L. Harden, William D. Marr, and Eric Lounsberry. At the conclusion of the hearing on May 19, the record was marked "Heard and Taken."

SBWGE and Staff each submitted an initial brief and reply brief. SBWGE also submitted a "draft order." A proposed Order was served on the parties.

II. NATURE OF SBWGE'S OPERATIONS

SBWGE is a wholly-owned subsidiary of Wisconsin Power and Light Company ("WPL"). WPL is a wholly-owned subsidiary of Alliant Energy Corporation. SBWGE is a utility company operating only within the State of Illinois and provides retail electric, gas and water utility service in and around the City of South Beloit, Illinois. SBWGE provides natural gas distribution service to approximately 6,800 residential, commercial and industrial customers in nine communities in northern Illinois including the City of South Beloit and surrounding parts of Winnebago County, Illinois and small sections of Stephenson County, Illinois. SBWGE also provides water service to approximately 2,000 residential, commercial and industrial customers in nine communities in northern

Illinois including the City of South Beloit and surrounding parts of Winnebago County, Illinois.

The City of South Beloit immediately adjoins the City of Beloit, Wisconsin, separated only by the state line running down the center of a paved street. The City of Beloit, Wisconsin is served by WPL. Residences and business establishments on the Illinois side and Wisconsin side receive gas service from an integrated gas distribution pipe connected to and supplied through a single gas main running along that street. WPL and SBWGE have contiguous service territories, with natural gas service provided by WPL on the Wisconsin side and SBWGE on the Illinois side. Gas service is not metered at locations where it crosses the state line. Meters measure gas service as it is delivered to the customers or used by the utility.

Similarly, SBWGE provides its water service from pipes connected to and supplied through a single integrated water distribution system with WPL, the Wisconsin portion of which was wholly owned by WPL during the test year, but most of which is now owned by the City of Beloit, Wisconsin. The water distribution systems of the respective entities are connected at several points along the state borderline. Water service is not metered at locations where it crosses the state line. Meters measure water service as it is delivered to the customers or used by the utility. SBWGE has a limited amount of water production facilities and until recently, WPL has supplied SBWGE with water supply. In December 2003, WPL sold its water production facilities to the City of Beloit. While WPL provides SBWGE with all services necessary to maintain and operate its water operations, the City of Beloit now provides SBWGE with its water supply.

SBWGE has no employees. Employees or contractors of WPL provide all administrative and operational functions of SBWGE. In addition to natural gas, the Company receives from WPL certain other services necessary to operate its gas utility business. The conditions of these services are established in a gas service contract between SBWGE and WPL approved by the Commission in Docket No. 97-0088.

SBWGE also receives certain other services from WPL that are necessary to operate a water utility business. The conditions of these services are established in a contract between SBWGE and WPL recently approved by the Commission in Docket No. 03-0462.

SBWGE’s last gas rate case was Docket 83-0577 in which an order was entered on September 18, 1984. SBWGE’s last water rate case was Docket 85-0505 and an order was issued on September 17, 1986.

III. SUMMARY OF SBWGE’S PROPOSAL; TEST YEAR

SBWGE proposes to increase its annual base rate gas operating revenues by $637,859, an increase of about 27%, and to increase its annual water operating revenues by $780,069, an increase of about 170%, which includes the rate impacts for the requested rider for the water surcharge. SBWGE states that increasing costs to operate its gas and water businesses coupled with the increasing levels of investment in the gas and water utility property have caused SBWGE's rate of return on its gas business to deteriorate to 3.68% for the gas operations and to -1.95% for its water operations for the 12 moths ending December 31, 2002. Since its last rate case, SBWGE experienced a change in the source of its water supply, and is requesting authorization to implement a purchased water surcharge.

SBWGE received its water supply from its parent, WPL, until WPL sold its water production facilities to the City of Beloit. As a result of the sale, WPL will no longer have available to it the water production facilities which have traditionally provided SBWGE with water supply. Those water production facilities now are owned by the City of Beloit. SBWGE now purchases water supply from the City of Beloit, and has requested a water surcharge to recover water supply costs.

The test year that SBWGE seeks to use is the historic 12-month period ending on December 31, 2002, with pro forma adjustments for purported known and measurable changes. No party opposed the use of this period, and the Commission concludes that the test year proposed by the Company is appropriate for purposes of this proceeding.

IV. RATE BASE

During the course of this proceeding, Staff proposed several adjustments to SBWGE's rate base including adjustments to water and gas cash working capital; accumulated depreciation reserve for gas plant; materials and supplies; customer deposits; and working capital allowance related to gas in storage. These adjustments were described in the testimony of the Staff witnesses. The effects are shown in the Schedules 3 and 4 of Appendices A and B to this Order. For purposes of this proceeding, the Company did not object to these adjustments. The Commission finds Staff's proposed adjustments to be reasonable and they are hereby adopted.

The rate base for SBWGE's water operations as of December 31, 2002, as adjusted, is shown in Schedule 3 of Appendix B to this Order, and may be summarized as follows:

Plant in Service for Water Operations	$6,243,258
Depreciation Reserve	(917,195)
Net Plant	5,326,063
Additions to Rate Base	
Construction Work in Progress without AFUDC	415
Materials and Supplies & Other Investments	-
Working Capital Allowance	23,869
Allocation of Rate Base – WPL Contract	-
Total Additions	24,284

Deductions from Rate Base	
Accumulated Deferred Income Taxes	(23,828)
Customer Advance for Construction	(1,316,179)
Customer Deposits	(11,687)
Total Deductions	1,351,694
Rate Base	$3,998,653

The rate base for SBWGE's natural gas operations as of December 31, 2002, as adjusted, is shown in Schedule 3 of Appendix A to this Order, and may be summarized as follows:

Plant in Service for Gas Operations	$12,977,388
Depreciation Reserve	(6,647,680)
Net Plant	6,329,708
Additions to Rate Base	
Construction Work in Progress without AFUDC	122,893
Materials and Supplies & Other Investments	557,591
Working Capital Allowance	178,825
Total Additions	859,309
Deductions from Rate Base	
Accumulated Deferred Income Taxes	(830,165)
Customer Deposits	-
Customer Advance for Construction	(68,258)
Total Deductions	898,423
Rate Base	$6,290,594

V. OPERATING REVENUES, EXPENSES AND INCOME

A. Water Operations

During the course of this proceeding, Staff proposed several adjustments to SBWGE's operating income statement including a reclassification of cost for allocated water supply, a source of water adjustment, interest synchronization, uncollectible expenses, amortization of rate case expense, and taxes other than income. These adjustments were described in the testimony of the Staff witnesses. The effects are shown in the Schedules 1 and 2 of Appendix B to this Order. For purposes of this proceeding, the Company did not object to Staff's proposed adjustments. The Commission finds that Staff's proposed adjustments to SBWGE's operating income statement are reasonable and should be adopted. Taking into consideration the overall rate of return on water rate base of 8.29% authorized below, the operating income statement associated with SBWGE's water operations for the test year ended

December 31, 2002 as adjusted, is shown in Schedule 1 of Appendix B to this Order, and may be summarized as follows:

Sale of Water	$ 788,325
Interdepartmental	710
Water Adjustment Clause Revenues	317,313
Total Operating Revenues	1,106,348
Uncollectible Expense	5,532
Source of Supply	317,313
Transmission/Distribution Expense	59,776
Customer Accounts	25,537
Administrative and General	105,642
Depreciation and Amortization	116,082
Taxes other than income	9,025
Total Operating Expense Before Income Taxes	638,907
State Income Taxes	25,151
Federal Income Taxes	149,890
Deferred Taxes and ITC net	(39,088)
Total Operating Expenses	774,860
Net operating Income	$ 331,488

B. Gas Operations

Staff also proposed several adjustments to SBWGE's gas operating income statement that the Company did not contest. Those adjustments include a PGA revenue and cost of gas adjustment, interest synchronization, uncollectible expenses, amortization of rate case expense, taxes other than income and an operating expense true-up adjustment. These adjustments were described in the testimony of the Staff witnesses. The effects are shown in Schedules 1 and 2 of Appendix A to this Order. The contested operating statement issue relates to SBWGE's shared savings program and is discussed immediately below.

1. Shared Savings Expense

a. Description of the Shared Savings Program and Relief Requested

In this proceeding, SBWGE seeks to recover, as part of its revenue requirement, $90,683 in deferred "Shared Savings" expenses. This amount represents one-third of the $272,048 amount of deferred Shared Savings expenses allocated to gas. (SBWGE Ex. MWS-1, Sch. C, L. 49-52; Tr. 69) The Company describes Shared Savings as a performance-based demand-side management program, available to all non-residential customers, that was designed and offered by SBWGE to help Illinois businesses make energy-saving improvements with little or no up-front investment of time or money. (SBWGE initial brief at 12-13)

Under the Shared Savings program, SBWGE representatives work with the customer to select gas-efficient equipment, suppliers and installers. SBWGE does not provide or install any of the gas-efficient equipment for customers. Rather, the customer, with SBWGE's assistance, retains local contractors and suppliers to provide and install the equipment. The customer sends the invoices to SBWGE and SBWGE reimburses the customer for the invoices pursuant to Shared Savings contracts. The customer repays SBWGE in monthly payments over three to five years. The customer also pays an administrative fee that recovers a portion of SBWGE's carrying costs for the reimbursement. The "buy down" amounts deferred by SBWGE, for which recovery is sought in this docket, represent the portion of SBWGE's carrying costs that was not collected from the participating customers with whom Shared Savings contracts were consummated during the period beginning in the mid-1990's through and including portions of 2002. (Tr. 54-57)

That is, for each such contract, the Company calculates the present value of the difference between the Company's pre-tax weighted cost of capital and the interest rate paid to SBWGE by the participant, and the sum of those amounts is the cost that the Company is requesting be recovered through its proposed amortization process. (Staff initial brief at 12, citing SBWGE Ex. MWS-1 at 13)

SBWGE says that under the Shared Savings programs, it guarantees that the savings in lower gas bills will pay for the improvements. When the payments are complete, the customer retains all the savings associated with the gas efficient equipment for the life of the equipment. (SBWGE initial brief at 15-16)

The Shared Savings program was suspended by the Company after 2002 due to concerns over whether it would be allowed to recover the carrying costs from ratepayers. According to SBWGE, it will again offer the program to gas customers if rate recovery is permitted in this docket.

According to SBWGE, it currently has 6,857 gas customers and during the period 1998 through 2003, 14 of those customers participated in the shared savings plan.

b. SBWGE's Position

SBWGE describes its Shared Savings program as a performance-based demand-side management program designed to help Illinois businesses make energy saving, cost saving and process improvements with little or no up-front investment of time or money. SBWGE states that the Shared Savings is available to all retail non-residential customers in Illinois, including retail, small businesses, factories, farms, hospitals, schools and state organizations.

SBWGE asserts that it has offered its demand side management program to help non-residential customers overcome hurdles in implementing energy savings projects. According to SBWGE, since customers have little or no knowledge concerning energy utilization and savings potential concerning their facilities and lack the time to perform the research necessary to identify and quantify energy efficient equipment, they are reluctant to propose projects based on energy savings. SBWGE claims another barrier is that the capital for energy efficiency improvements are often difficult to obtain or cannot compete with the capital needs of other revenue producing aspects of a customer's business. The Company asserts that most corporations allocate capital based upon financial factors, such as return on investment, and many energy efficiency projects are not perceived to have sufficiently competitive paybacks to be considered for implementation. (SBWGE initial brief at 14)

SBWGE contends that the Shared Savings program, like the Bright Ideas for Business program before it, successfully removes these barriers by offering information, the time and money needed to make the improvements and a guarantee of savings through its Shared Savings energy efficiency projects. SBWGE claims that the program assists customers who are not able to invest the time necessary to learn about the most efficient technology or to install equipment that achieves energy savings. (SBWGE initial brief at 12-13) SBWGE also says it provides technical support engineers to provide detailed solutions to customer applications concerning energy efficiency. (SBWGE initial brief at 14-15)

SBWGE states that the company's Bright Ideas for Business program was approved by the Commission in Docket No. 88-0199. SBWGE asserts that in its Order in Docket 88-0199, the Commission approved the implementation of SBWGE's energy conservation programs in its Illinois service territory. SBWGE claims the Shared Savings Program, instituted in 1998, is similar to the Bright Ideas for Business Program approved by the Commission, and that only the name and accounting treatment have changed. (SBWGE initial brief at 13)

In Section III.C.3 of its brief, "Request for Recovery", SBWGE submits that on March 24, 1998, Staff agreed with the methodology by which SBWGE would account for its Shared Savings energy efficiency service. (SBWGE initial brief at 16, citing SBWGE Ex. JO-2 at 4) SBWGE acknowledges that Staff did state that recognition of the accounting procedures should not be construed as approval of any ratemaking treatment, and that Staff has not reviewed the program and has not offered an opinion as to the propriety of the Shared Savings program.

SBWGE asserts that some Shared Savings expenses were incurred in the test year and that some expenses were “known and measurable” changes outside of the test year, and is requesting a pro forma adjustment for those changes. (SBWGE initial brief at 16-17)

In Section III.C.4 of its brief, the Company addresses “Staff’s Objections”. It is SBWGE’s position that despite Staff’s arguments that the costs should be disallowed, Staff offered no evidence that expenses related to the Shared Savings program are unjust and unreasonable. SBWGE argues that absent a showing its SBWGE’s Shared Savings program is unjust and unreasonable, the Commission must reject Staff’s recommendation to exclude SBWGE’s Shared Savings expenses. (SBWGE initial brief at 18)

SBWGE argues that despite the fact that Section 8-402 of the Act has been repealed and Illinois law no longer requires least-cost planning, the Company continues to evaluate and implement demand side options today. SBWGE claims it is obligated to evaluate its demand side options under Section 1-102 of the Act. SBWGE says it has found its Shared Savings program to be successful in reducing gas demand. SBWGE believes its Shared Savings program is an effective tool in managing its peak demand and that Shared Savings helps SBWGE meet its customers demand for gas services at the least cost. SBWGE argues that Shared Savings is a cost of doing business, and as such it is proper for SBWGE to seek recovery. SBWGE asserts that the costs for the Shared Shaving’s program confer a benefit to all customers, and therefore on ratepayers. (SBWGE initial brief at 18-19)

SBWGE claims that its Shared Savings program provides societal benefits of over $2.50 for every $1.00 invested. According to SBWGE, with a benefit-to-cost ratio of 2.5, everyone in SBWGE’s Illinois service area receives $2.50 in benefits for every dollar it invests in the Shared Savings program. SBWGE contends that from a participant perspective, Shared Savings is estimated to have resulted in nearly $1.6 million in net benefits during 1998-2002, or a benefit-to-cost ratio of 3.24. (SBWGE Ex. JO-4) It is SBWGE’s position that its customers benefited from Shared Savings, and that Staff has not established that the costs are unreasonable. (SBWGE initial brief at 19)

In response to Staff’s suggestions that the Shared Savings costs must be excluded because they contain some past expenses and would amount to retroactive ratemaking and single-issue ratemaking, SBWGE argues that any deferred balance (debit or credit) is amortized in subsequent test years subject to review within rate proceedings. The Company claims that this ensures that there is always a perfect matching of expense and revenue. SBWGE does not believe that a pro forma adjustment would trigger retroactive ratemaking or single-issue ratemaking. In SBWGE’s view, single-issue ratemaking is not triggered and since no refund is given and no surcharge created, retroactive ratemaking is not triggered. (SBWGE initial brief at 20)

SBWGE suggests that any reliance on the reasoning the Illinois Supreme Court established in *Illinois Bell Telephone Co. v. Illinois Commerce Commission*, (1973), 55 Ill 2d. 461, 303 N.E.2d 364, ("*Illinois Bell 1973*") is misplaced. (SBWGE initial brief at 20) SBWGE says in that case the Court established that operating costs are recoverable from ratepayers only if the utility demonstrates that the expense provides a direct benefit to customers or to services supplied to customers. SBWGE says that although it believes it has established that Shared Savings confers benefits on all of its customers, the Illinois Supreme Court later found that the *Illinois Bell 1973* holding does not preclude recovery of legally mandated costs of doing business. (SBWGE initial brief at 20, citing *Citizens Utility Board v. Illinois Commerce Commission*, 166 Ill. 2d 111, 651 N.E.2d 1089, 1095, 209 Ill. Dec. 641 "*Citizens Utility Board*")

SBWGE asserts that in its decision in *Citizens Utility Board*, involving the Commission's Order in the generic coal tar proceeding in Dockets 91-0080 through 91-0095, the Illinois Supreme Court disagreed with the Citizens Utility Board's narrow view of what types of costs and expenses benefit customers. SBWGE says the Court agreed with the Commission and the utilities that expenses commonly incurred to comply with the mandate of Federal and State law have historically been recoverable from ratepayers. SBWGE says the Court noted that income taxes are a legally mandated cost of doing business and are recoverable from ratepayers as a component of a utility's revenue requirement. According to SBWGE, the payment of taxes can be seen as benefiting the ratepayer, because a public utility must fulfill its tax obligations to remain in business. (SBWGE initial brief at 20-21)

SBWGE next contends that it is obligated to consider all supply and demand options under the Act. SBWGE argues that demand side management programs such as the Shared Savings are widely accepted by the utility industry and commissions across the country as demand options. According to SBWGE, Shared Savings allows customers to overcome financial hurdles in acquiring energy efficient equipment and business practices; this in turn keeps SBWGE's demand down. SBWGE contends that this allows the Company to better manage its peak demand gas costs and avoids costs it may otherwise expend expanding its system to meet that demand. By implementing demand options, SBWGE believes it has met its customer demand for public utility service at the least cost as mandated by the Act and in doing so has conferred benefits in the form of savings to its customers. (SBWGE initial brief at 21)

In its reply brief, SBWGE argues Staff's position oversimplifies the Shared Savings program and how incentives are created to encourage customers to participate in energy efficiency programs. (SBWGE reply brief at 3)

SBWGE also contends that while Staff implies that the Shared Savings participants do not pay for the full amount of their loans, this is simply not the case. (SBWGE reply brief at 3) According to the Company, the customer pays for the full amount of the loan and therefore the total cost of the equipment plus a portion of the capital carrying costs of the loan through an administrative fee. SBWGE claims that the customer does not pay the full interest cost of the loan. SBWGE states that in order to create an incentive to customers to participate in energy efficiency programs, a utility must offer the customer some kind of reason to participate. SBWGE contends that in the absence of the program, the customer has no incentive to conserve energy because of SBWGE's relatively low electric and gas rates. (SBWGE reply brief at 4)

In response to other Staff arguments, SBWGE comments that Staff seems to misunderstand that SBWGE is only requesting that the deferred costs be matched against its future revenues, and future revenues would not include any Shared Savings expenses incurred after 2002. (SBWGE reply brief at 6, citing Staff initial brief at 13) According to the Company, any new Shared Savings expenses would be deferred until the next rate case, if SBWGE is allowed to recover its prudently incurred Shared Savings expenses in this rate case.

The Company also argues in its reply brief that in Docket No. 95-0032, the Commission allowed Peoples Gas Light and Coke Company to terminate its demand-side management rider and to amortize the deferred expenses relating to demand side management costs. (ICC Docket No. 95-0032 at page 11, November 8, 1995) SBWGE says the Commission stated that it intended for prudently incurred costs to be fully recoverable, and rejected Staff's position that the deferred costs should not be recoverable. (SBWGE reply brief at 6)

c. Staff's Position

Staff's position is that the cost of the program to SBWGE should not be recovered from the Company's customers but rather from the participants in the program. Staff argues that the savings sharing program benefited only select commercial and industrial customers and it is unfair to ask that the entire customer base subsidize the select few who receive the direct benefits of the cost. Staff is also concerned that the Company's proposal to recover previously incurred expenses would in effect create a "surcharge rider" for the shared savings program. Staff says this is because the previously incurred costs would be compared against future recoveries of shared savings cost and would then be adjusted to reflect under or over recoveries. (Staff initial brief at 12-13)

Staff contends that coal tar costs are recovered through a rider and are mandated by law, whereas, the Shared Savings program is optional and is not appropriate for recovery through base rates. In addition, Staff states that what the Company is proposing is that a surcharge be embedded in base rates and that a reconciliation occur when rate cases are filed. Staff claims that the very reason for coal tar, purchased gas, and similar riders is that base rates, while constructed initially from specific costs lose the identity of those costs when charged to customers. According to Staff, rates that are charged to customers are neither separated, nor separable, into their individual components. In Staff's view, to reconcile savings sharing costs with revenues, various assumptions would need to be made resulting in an exercise of single-issue ratemaking. (Staff initial brief at 14)

Staff claims that SBWGE's argument is in essence that all customers, and even all of society, benefit when a few customers reduce their energy consumption. Staff, however, believes it is unreasonable to expect that all customers should pay the interest cost on behalf of participant customers who buy equipment that provides a savings in gas cost to the participant. (Staff initial brief at 14)

As for SBWGE's reliance on the Commission's Order in Docket 88-0199, Staff notes that the Order in Docket 88-0199 states, "IT IS FURTHER ORDERED that nothing in this Order shall be construed as a determination that the costs incurred in implementing these programs will automatically found to be (sic) reasonable for inclusion as expenses in Petitioner's next rate proceeding". Staff claims this controverts any precedent value that it might otherwise have. (Staff initial brief at 14-15)

Staff also disputes the Company's claim that if the Shared Savings program results in reduced gas consumption for the participants, system peak consumption will be reduced and gas cost to all customers will be reduced. Staff argues that no conclusions of any kind can be made relative to this contention because the savings in peak demand that might have resulted from the Shared Savings program has not been quantified. (Staff initial brief at 15)

According to Staff, the fact that there might be incidental benefits associated with the Shared Savings program is irrelevant to the question of who should pay for the cost of the loans that the Company incurs as a result of the program. Staff contends that ratemaking policy requires that the customers who cause the cost should pay the cost. Staff states that in this case, the participants in the program incur the cost of the loans because they want to reduce the amount of gas, and associated gas cost, that they use. Staff believes it is reasonable that the participants in the program pay the cost of the loans that provide them with the benefit of reduced gas cost. (Staff initial brief at 15-16)

Staff disputes SBWGE's claim that denying recovering of costs associated with the Shared Savings program would penalize the Company. Staff argues that the Company has never been granted authority to recover the cost of shared savings and the Order in Docket 88-0199 indicates that the recovery of shared savings is not a settled issue. In Staff's view, while the Company might disagree with Staff's position, any suggestion that it is being treated unfairly is without merit. (Staff initial brief at 16)

Staff also takes issue with SBWGE's assertion that it seeks to recover future costs, not deferred costs. (Staff initial brief at 16, citing SBWGE Ex. MWS-3.0 at 6-9) According to Staff, in its direct testimony, the Company claims that it wants to recover cost incurred from 1998 through 2002 and argues that the inclusion of deferred costs in revenue requirement is proper. (Id., citing SBWGE Ex. MWS-1 at 13-14, SBWGE Ex. MWS-2 at 8) In Staff's view, while the question of whether the cost is a deferred cost or a future cost is secondary to the more important issue of who incurs the cost, any suggestion in surrebuttal testimony that the shared savings cost the Company seeks to recover is not a deferred cost should be ignored. (Staff initial brief at 16-17, citing SBWGE Ex. JO-2 at 7, Tr. 56)

According to Staff, the Company has not explained why it should be permitted to recover past costs from future customers paying for future service. With regard to the Company's reliance on the *Citizens Utility Board* decision, Staff claims SBWGE fails to consider *Business and Professional People for the Public Interest v. Illinois Commerce Commission*, 146 Ill. 2d 175, 240-241 (1991) ("*BPI II*"). Under BPI II, Staff argues, these types of costs are period costs subject to test-year principles and therefore, they cannot be deferred and included in rates to be recovered from future operations. (Staff reply brief at 8)

d. Commission's Analysis and Conclusions

i. Background and Summary of Positions

As explained above, the Company describes Shared Savings as a performance-based demand-side management program, available to all non-residential customers, that was designed and offered by SBWGE to help Illinois businesses make energy-saving improvements with little or no up-front investment of time or money.

Over Staff's objections SBWGE seeks to recover, as part of its revenue requirement, $90,683 in deferred Shared Savings expenses. This amount represents one-third of the $272,048 amount of deferred Shared Savings expenses allocated to gas operations. The three-year amortization period was based on the projected life of the rates.

Under the Shared Savings program, SBWGE does not provide or install any of the energy-efficient equipment for customers. Rather, the customer, with SBWGE's assistance, retains contractors to provide and install the equipment. The customer sends the invoices to SBWGE and SBWGE reimburses the customer for the invoices pursuant to a Shared Savings contract. The customer repays SBWGE in monthly payments over three to five years. The customer also pays an administrative fee that recovers a portion of SBWGE's carrying costs for the reimbursement. The amounts deferred by SBWGE, for which recovery is sought in this docket, represent the portion of SBWGE's carrying costs that was not collected from the participating customers with whom Shared Savings contracts were consummated from 1993 through and including portions of 2002.

To arrive at the amount recorded for each such contract, the Company calculated the present value of the difference between the Company's cost of capital and the interest rate paid to SBWGE by the participant. The sum of those amounts, which have been accumulating from 1993 through 2002, is the cost that the Company is requesting be recovered through its proposed amortization process. (Staff initial brief at 12, citing SBWGE Ex. MWS-1 at 13)

The parties' positions are articulated in their testimony and briefs, as summarized above, and will not be repeated in detail here. Staff's main argument is that that the savings sharing program benefited only select commercial and industrial customers, and that it is unfair to ask the entire customer base to subsidize the select few who receive the direct benefits of the cost. In Staff's view, the cost of the program to SBWGE should not be recovered from the Company's customers but rather from the participants in the program. Staff also takes issue with what it characterizes as the Company's surrebuttal argument that it seeks to recover future costs, not deferred costs.

SBWGE argues that the Shared Savings program is an effective demand-side management program that has been successful since its inception in enabling customers to reduce energy consumption and in assisting the Company in managing peak demand, and that it should be permitted to recover the costs in question through rates. The Company also claims the economic analysis utilized in the program was approved by the Commission in Docket 88-0199, and that the current accounting methodology was approved by the Commission Staff in 1998.

ii. Commission Analysis and Conclusions

Having reviewed the record, the Commission first observes that demand-side management programs, whether or not specifically mandated by statute, can provide important benefits in the form of lower energy consumption by consumers and reduced peak demands on the utility's system. Further, the fact that a program is offered to only some of the customer classes does not preclude cost recovery. Although Staff argues that only 14 customers have actually used this program since 1998, the record is clear that the program has been available to all non-residential customers. With regard to SBWGE's Shared Saving program, as noted above, the Commission's Order in Docket 88-0199 found that the Company performed a reasonable economic analysis for the program, and the Company asserts that the same methodology has been used in evaluating potential projects since that time.

In the instant rate docket, however, there are several factors that complicate the process of assessing the Company's proposed recovery of the costs in question, one of which is the long period of time the carrying costs have been deferred without any determinations on rate recovery. While the Company focused on the period of 1998 through 2002 in presenting its proposal in this docket, the record shows that the deferred amounts for which recovery is sought have in fact been accumulating since 1993.

Under the Commission's "test year" procedures in 83 Ill. Adm. Code 285, a utility seeking rate relief selects either a historic or future test year. In its filing, SBWGE selected a historic test year consisting of the 12 months ended December 31, 2002, with pro forma adjustments. Therefore, the statement of revenues and expenses, or "operating statement" provided by the Company, was for the 12-month period ending

December 31, 2002. In terms of the nature of the Shared Savings costs in question, the Company characterizes them as "Shared Savings expenses." (SBWGE initial brief at 12, 17-18, 20)

Generally speaking, under the test year concept, an operating statement for a test year will include a reasonable level of ongoing operating expenses occurring during that period, subject to possible adjustments to reflect pro forma adjustments, while operating expenses that occurred in years prior to the test year will not be included in the test year operating statement. Section 287.40 of 83 Illinois Administrative Code 287 provides in part that pro forma adjustments may be proposed to "reflect changes … where such changes occurred during the selected historical test year or are reasonably certain to occur subsequent to the historical test year within 12 months after the filing date of the tariffs and where the amounts of the changes are determinable."

Thus, the inclusion of "deferred" operating expenses in proposed revenue requirement in a test year rate filing is problematic, and the inclusion of deferred expenses is the exception, not the rule. The fact that such expenses may have been reasonably incurred does not constitute an exception to test year rules.

In the instant case, in support of its position, the Company relies on the Illinois Supreme Court's holding in the generic coal tar proceeding, *Citizens Utility Board.* A review of that decision, however, indicates that the coal tar proceeding was simply not a traditional rate case. This point is significant, as test year rules apply only to a traditional rate case.

As noted by the Court in *Citizen's Utility Board*, some parties argued that the Commission's approval of a rider recovery mechanism in its Order in the consolidated coal tar dockets was contrary to the Commission's own test year rules and the decision in *BPI II*. In addressing this issue, the Court in *Citizen's Utility Board* observed, "The test year rule is designed to avert mismatching of revenues and expenses that might permit a utility to inaccurately portray a higher need for rate increases." After discussing the test-year rule, the Court stated, "We agree with the Commission and the utilities that the test-year rule seeks to avoid a problem not present when expenses are recovered through a rider." (166 Ill. 2d 111 at 139-40) The Court added, "As the Commission notes, the case at bar does not attempt to evaluate or adjust all aspects of the utilities' base rates, and thus the test-year filing is not a prerequisite." (Id.)

The instant case, on the other hand, is a general rate proceeding, and test year rules clearly apply. Generally speaking, as explained above, deferred expenses that occurred in years prior to the test year are not eligible for recovery just because they were reasonably incurred. Rather, recovery of deferred expenses is the exception, not the norm. Where permitted, such recovery has generally been preceded by prior authorization to defer the expenses and/or approval of the recovery mechanism, or by rule.

With respect to of the Shared Savings demand side management or "DSM" program offered by SBWGE, implementation of the program was preceded by entry of a Commission Order in Docket 88-0199 that approved the Company's Shared Savings program for implementation. However, that Order did not approve any rate recovery methodologies, such as riders that were used by some utilities to recover demand side management costs incurred in least-cost programs. Rather, the Order specifically indicated that no determination was being made as to whether or not the program would be deemed reasonable for recovery for ratemaking purposes. The Order did direct the Company to file annual reports identifying costs incurred and results of any economic analyses performed. The record in the current docket is silent as to whether these filings have been made. A review of the Order in Docket 88-0199 also reveals no findings specifically authorizing the Company to defer the expenses in question.

As stated by the Company, in March of 1998, some 10 years after the proceeding in Docket 88-0199, it received a letter dated March 24, 1998 from the Commission's Accounting Department in response to a request made by the Company on February 27, 1998. That letter of March 24, 1998 stated that certain proposed accounting procedures are appropriately applied to the Shared Savings program in Illinois. (SBWGE Ex. JO-2) While the letter stated that the recognition contained therein was not to be construed as approval for ratemaking purposes and that no position was taken on the proprietary of the program itself, it appears from a review of the exhibit that the proposed accounting procedures found appropriate in the letter did specifically contemplate certain deferred accounting entries. Further, there is no evidence that deferrals recorded since that time have been inconsistent with the accounting procedures found appropriate.

Given the information in SBWGE Exhibit JO-2 relative to deferrals in and after 1998, together with the Order in Docket 88-0199 in which the Commission found that the Company performed a reasonable economic analysis for the program and approved its implementation, the Company's assertions that the same methodology has been used in evaluating potential projects through 2002, and other information of record and observations made above regarding the program, an argument can be made that the Company should be allowed to recover some ratable or amortized portion of its Shared Savings expenses incurred and deferred since receipt of the 1998 letter. That is, while none of these factors alone may be sufficient to support rate recovery, when viewed in combination, such an argument warrants consideration.

With regard to deferrals from earlier periods, however, given the facts in this case and the reasons set forth above, to allow the Company to reach all the way back to 1993 to recover the deferred expenses in question would not be consistent with good test year ratemaking rules and practices. No recovery of deferred amounts should be allowed for the pre-1998 periods, the earliest of which pre-dates the 2002 test year by almost 10 years.

To return to the analysis of whether the Company should be allowed to recover amounts deferred subsequent to the accounting authorizations in the 1998 letter based on the above discussion, the Commission observes that a significant problem exists because such amounts are not quantified in the record. As noted above, the deferred amount that is identified by the Company, and for which recovery is sought, is an accumulated total of deferrals dating back to 1993 not 1998, the Company's references to the period of 1998 to 2002 notwithstanding.

Further, there does not appear to be sufficient information in the record to ascertain the portion of the total amount that is attributable to the 1998 to 2002 period, or for any individual year within such period for that matter. Likewise, there does not appear to any methodology of record by which such a calculation could be made.

Accordingly, based on the record in this case, the Commission concludes that no recovery of deferred Shared Savings costs should be allowed as part of the Company's approved revenue requirement in this docket.

As indicated above, another argument made by the Company relatively late in the case is that "SBWGE has established that some Shared Savings expenses were incurred in the test year and that some expenses were known and measurable changes outside of the test year, and as such is requesting a pro forma adjustment for those changes." (SBWGE initial brief at 17) In the context of this Shared Savings issue, the Company's purpose in making this argument is somewhat unclear. Assuming the Company is seeking to recover a test year amount of such Saving Sharing program expenses as an alternative to recovering previously deferred amounts, or in combination with it, a similar quantification problem exists as the one discussed above.

The starting point for such a proposal would be the amount in the historic test year, which is the 12 months ending December 31, 2002. As noted above, however, the amount for 2002 is not identified in the record. Hence, whether the 2002 amount would be a reasonable allowance for test year purposes, with or without pro forma adjustments, cannot be determined. Furthermore, under Commission rules, pro forma adjustments to test year amounts may be proposed to "reflect changes . . . where such changes occurred during the selected historical test year or are reasonably certain to occur subsequent to the historical test year within 12 months after the filing date of the tariffs and where the amounts of the changes are determinable." In the current case, it is difficult to see how one-third of an aggregate dollar total from a prior 10-year period would meet the standard in the rule relating to pro forma adjustments to test year results. In addition, whether it would be appropriate to include the 2002 amount in revenue requirement for a program that has since been suspended is a question not reached in this Order.

A similar problem exists with an argument by the Company that any deferred balance would be amortized in subsequent test years subject to review within rate proceedings, that this ensures that there is always a "perfect matching" of expense and revenue, and therefore there is no under or over recovery of the Shared Savings expenses. (SBWGE initial brief at 20) Again, the relationship between this argument and the proposed recovery of previously deferred amounts is somewhat unclear, as are some of the mechanics of such a proposal. In any event, the starting point for, and a component of, such an approach would appear to be a test year allowance in base rates. As explained above, no reasonable amount for that purpose has been established in this docket.

Also, generally speaking, inclusion in base rates of a rate recovery mechanism designed to reconcile, on a going forward basis, actual expenses for a specific item with expense amounts included in base rates or with related revenues, is not consistent with base rate test year ratemaking in the State of Illinois. The types of rate recovery mechanisms that are designed to track and reconcile item-specific expenses and/or revenues on an ongoing basis for eventual matching and adjustment, such as riders, are alternatives to setting base rates via the test year ratemaking process, not part of it, as explained by the Illinois Supreme Court in the *Citizen's Utility Board* case cited above.

In conclusion, based on the record presented, the Commission finds that no recovery of shared savings costs should be allowed as part of the Company's revenue requirement in this proceeding.

C. Approved Operating Income Statement for Gas Operations

Taking into consideration the conclusions reached above as well as the overall rate of return on gas rate base of 8.41%, authorized below, the operating income statement associated with SBWGE's gas operations for the 12 months ended December 31, 2002 as adjusted is shown in Schedule 1 of Appendix A to this Order, and may be summarized as follows:

Operating Revenues	$ 2,596,532
Interdepartmental	36,949
PGA Revenues	3,720,805
Total Operating Revenues	6,354,286
Uncollectible Expense	31,771
PGA Cost of Gas	3,720,805
Distribution Expense	420,632
Customer Accounts	175,926
Customer Service and Info	210,829
Sales Expense	127
Administrative and General	623,084
Depreciation and Amortization	408,369
Taxes other than income	18,308
Total Operating Expense Before Income Taxes	5,609,851
State Income Taxes	40,216

Federal Income Taxes	177,525
Deferred Taxes and ITC net	(2,345)
Total Operating Expenses	5,825,247
Net operating Income	$ 529,039

VI. COST OF CAPITAL

Three witnesses submitted testimony regarding SBWGE's cost of capital. Mr. Martin Seitz presented the Company's analysis of the capital structure, cost of debt, cost of preferred stock and weighted average cost of capital ("WACC"). (SBWGE Ex. MWS-1, Schedule D-1) Mr. Enrique Bacalao, Assistant Treasurer and Director of Financing for Alliant Energy Corporate Services, Inc., presented the Company's analysis of the cost of equity. (SBWGE Ex. EB-1) Ms. Janis Freetly, Senior Financial Analyst in the Finance Department of the Financial Analysis Division, presented Staff's analysis of SBWGE's capital structure, costs of debt, cost of preferred stock, cost of common equity and WACC. (Staff Ex. 4.0)

The Company did not object to Staff's proposed capital structure or costs of short-term debt, long-term debt, and preferred stock for the gas and water operations of SBWGE. With regard to the appropriate cost of equity for SBWGE's gas operations and water operations, however, SBWGE and Staff are in disagreement.

A. Capital Structure

Company witness Seitz recommended adopting WPL's December 31, 2002 capital structure consisting of $57,354,833 of short-term debt (4.30%), $535,783,849 of long-term debt (40.17%), $59,963,000 of preferred stock (4.50%), and $680,603,006 of common equity (51.03%).

Staff witness Freetly proposed adjusting the Company's short-term debt balance to reflect the average monthly balance for the 12 months surrounding the December 31, 2002 measurement date (i.e., July 2002 through June 2003). To calculate the balance of short-term debt, she first calculated the monthly ending net balance of short-term debt outstanding each month in accordance with 83 Ill. Adm. Code 285.4020. Next, she calculated 12 monthly averages from the monthly ending net balances of short-term debt. Finally, the average of the 12 monthly average net balances of short-term debt for July 2002 through June 2003 was computed. (Staff Ex. 4.0 at 4-5 and Schedule 4.02)

Ms. Freetly adjusted the balance of long-term debt to reflect the balances of unamortized discount and issue expense resulting from straight-line amortization of the original amount from WPL's FERC Form 1. (Staff Ex. 4.0 at 11-12 and Schedule 4.03) She also adjusted the balance of preferred stock by adding the unamortized premium on preferred stock, which she also subtracted from the balance of common equity. (Staff Ex. 4.0 at 5-6 and Schedule 4.04) Ms. Freetly further adjusted the balance of common equity by adding back the deductions the Company made to eliminate WPL's non-utility investments. (Staff Ex. 4.0 at 5-6)

As a result of her adjustments to the balances of short-term debt, long-term debt, preferred stock and common equity, Ms. Freetly recommended a capital structure comprised of $33,164,078 of short-term debt (2.58%), $509,794,069 of long-term debt (39.73%), $60,218,000 of preferred stock (4.69%), and $680,073,615 of common equity (53.00%). For purposes of this proceeding, the Company did not object to Staff's proposed capital structure.

The Commission finds that Staff's recommended capital structure is reasonable and it is adopted for purposes of establishing the overall cost of capital or weighted average cost of capital in this proceeding.

B. Costs of Debt and Preferred Stock

The Company proposed a cost of short-term debt of 1.84%, based on the weighted average interest rate actually paid over the year ended December 31, 2002. (SBWGE Ex. MWS-2, Schedule D-2) Staff adjusted the cost of short-term debt to reflect current rates, which resulted in a 1.00% proposed cost of short-term debt. (Staff Ex. 4.0 at 10-11) The Company did not object to Staff's proposed cost of short-term debt.

The Company proposed a cost of long-term debt of 6.95%. (SBWGE Ex. MWS-2, Schedule D-3) Staff adjusted the annualized amortization of debt discount and issue expense to reflect straight-line amortization of the respective unamortized balances over the remaining life of each issue. Staff also updated the interest rate on variable rate long-term debt to current rates. These adjustments resulted in a proposed cost of long-term debt of 7.30%. (Staff Ex. 4.0 at 11-12 and Schedule 4.03) The Company did not object to Staff's proposed cost of long-term debt.

SBWGE proposed a 5.52% cost of preferred stock. (SBWGE Ex. MWS-2, Schedule D-4) Staff's recommendation for the embedded cost of preferred stock is 5.50%. Including the premium on capital stock in the balance of preferred stock resulted in a slightly lower cost than SBWGE presented. (Staff Ex. 4.0 at 12, Schedule 4.04) The Company did not object to Staff's proposed cost of preferred stock.

The Commission finds that Staff's recommended cost of short-term debt of 1.00%, cost of long-term debt of 7.30%, and cost of preferred stock of 5.50%, are reasonable and should be adopted for purposes of establishing the weighted average cost of capital in this proceeding.

C. Cost of Common Equity

1. SBWGE's Proposal

According to the Company, the Commission should approve a return sufficient to maintain the financial integrity of SBWGE; provide a return to shareholders consistent with the returns available from investment alternatives of corresponding risk; and to attract sufficient capital at reasonable costs to support SBWGE's business operations and fulfill its duty to serve the public during both favorable and unfavorable conditions in the capital markets. (SBWGE initial brief at 25-28)

SBWGE's common stock is not openly traded in the market, since SBWGE is wholly owned by Wisconsin Power and Light Company ("WPL"). WPL's common stock, in turn, is not openly traded in the market, since WPL is wholly owned by Alliant Energy Corporation ("AEC" or "Alliant Energy"). SBWGE states that due to its modest size, SBWGE depends on WPL for its funding, and WPL depends on AEC to obtain additional common equity. According to the Company, to estimate SBWGE's cost of common equity, Mr. Bacalao did not rely on AEC's marginal cost of equity but instead he created a proxy group of companies comparable to SBWGE and WPL. (SBWGE initial brief at 24-25) After developing the proxy group, Mr. Bacalao applied five cost of equity estimation techniques.

To select the firms in his proxy group, Mr. Bacalao started by looking at all of the companies followed by the Value Line Investment Survey. From the Value Line survey, he selected those companies that have a Value Line Safety Rank of 2 and an S&P long-term corporate credit rating similar to that of WPL. The Company says that when Mr. Bacalao drafted his testimony in October of 2003, WPL had an S&P long-term corporate credit rating of "A-." SBWGE asserts that the Stability Index for the company as well as the company's financial strength primarily determines the Safety Rank. (SBWGE initial brief at 29)

SBWGE claims that the use of Safety Rank 2 and S&P rating as selection criteria was done in order to select companies with a similar risk profile to that of WPL and SBWGE. The Company says that Safety Rank of WPL and SBWGE are not directly observable in the Value Line reports; therefore Mr. Bacalao used the Safety Rank of WPL's parent, Alliant Energy, as the starting point in establishing the equity investment risk of SBWGE. SBWGE states that there are 195 companies with a Safety Rank of 2 and 23 companies that have a Safety Rank of 2 and an S&P credit rating of "A-." SBWGE indicates that Mr. Bacalao used these 23 companies as the comparables or proxy group for determining the appropriate return on equity estimate for SBWGE. The Company adds that Mr. Bacalao eliminated those companies that were missing any relevant data needed for any one of the five models for that respective model. (SBWGE initial brief at 29)

After developing the proxy group, Mr. Bacalao applied the following five cost of equity estimation techniques: (1) the historical return on equity ("ROE") model; (2) the forecasted ROE model; (3) capital asset pricing model ("CAPM"); (4) the discounted cash flow ("DCF") model; and (5) the risk premium model. (SBWGE initial brief at 25)

Mr. Bacalao's historical ROE model shows the actual returns on book equity that were achieved during the period from 1992 to 2001 as reported by Value Line. The Company claims that analysis of actual book returns instead of market-based returns provides a less biased view of return levels given the rapid increase in stock market valuations during recent years. SBWGE states that the average annual ROE of the companies in the proxy group ranged from a low of 13.17% in 1995 to a high of 16.44% in 2000 and that the average ROE over the period 1992 to 2001 for the sample companies was 14.02%. (SBWGE initial brief at 30)

For the forecasted ROE model, the Company states that an analysis of forecasted book returns was used instead of forecasted market based returns for the same reasons as given for the historical ROE model. SBWGE contends that looking at historical and forecasted book ROE's enhances comparability between the returns of these two models. Using Value Line Reports, Mr. Bacalao used the forecasted ROE model to develop the forecasted returns on book equity from 2002 to 2007. Mr. Bacalao determined that the average annual forecasted ROE of the companies ranged from a low of 13.24% in 2002 to a high of 14.05% in 2005-2007, with a midpoint estimate of 13.85%. (Id.)

In implementing the CAPM, Mr. Bacalao used the following formula:

$R_e = r_f + \text{Beta} \times (r_m - r_f)$

where: R_e = expected return on stock, r_f = risk-free rate, Beta = the measure of market risk, and r_m = expected market return.

The witness expressed concerns regarding the levered betas provided by the Value Line Reports. He claims that since the companies in the sample have a different leverage, their betas as shown in Value Line are not comparable. The Company says that to make them comparable, Mr. Bacalao took the levered betas, un-levered them, and then re-levered them based on the estimated leverage of WPL. According to SBWGE, the book equity of Alliant Energy Corporation and WPL, in connection with the market to book equity ratio of Alliant Energy Corporation equity, were used to calculate an approximate equity market capitalization for WPL since WPL does not have a publicly traded stock. The Company states that the formula showing the relationship between a levered and un-levered beta was taken from Ibbotson Associates Cost of Capital Quarterly Yearbook for 1999. (SBWGE initial brief at 31)

According to SBWGE, the average re-levered beta of the sample is 0.94, which implies that if these companies had leverage similar to that of WPL, they would have a market risk slightly less than that of the market portfolio. Mr. Bacalao used the expected 2004 30-year U.S. Treasury bond yield of 5.70% as an estimate of the risk-free rate. Additionally, based on the arithmetic mean return of the Large Company

Stocks, Mr. Bacalao estimated the expected market return to be 12.70% and an equity risk premium of 7.0%. Using this data, Mr. Bacalao's first CAPM calculation yielded an expected cost of equity of 12.27%. (SBWGE initial brief at 31-32)

In his second CAPM calculation, Mr. Bacalao used all of the same data as in his first, except for a different estimate of the equity risk premium of 7.4% which is allegedly the long horizon expected equity risk premium for large company stocks. Mr. Bacalao's second CAPM calculation yielded an expected cost of equity of 12.65%. The average of Mr. Bacalao's two CAPM estimates is 12.46%. (SBWGE initial brief at 32)

With regard to his DCF analysis, Mr. Bacalao used a two-stage DCF model shown on page 33 of the Company's initial brief. He used five-year annual forecasted dividends from Zach's Investment Research for the first stage growth rate and a terminal annual growth rate of 7.979% that is intended to represent the long-run nominal GDP growth rate of the economy. The Company says the source of historical nominal GDP growth rates of the U.S. economy used by Mr. Bacalao is the International Monetary Fund web site's World Economic Outlook Database. Mr. Bacalao's DCF analysis produced an average cost of equity of 12.32%. (SBWGE initial brief at 32-34)

According to SBWGE, the risk premium model calculates a cost of equity based on a risk-free rate and the equity risk premium. In performing his risk premium analysis, Mr. Bacalao used the formula:

$$r_e = r_f + p$$

where: r_e = expected return on equity, r_f = risk-free rate, and p = equity risk premium.

The Company says three investment horizons were used - long, intermediate, and short - because both the risk-free rate and the equity risk premium can differ depending on which horizon is used. In the long-horizon calculation, the Company used the 2004 expected 30-year Treasury bond yield, 5.70%, to represent the risk-free rate. In the intermediate-horizon calculation, the Company used the 10-year Treasury bond yield of 4.95% to represent the risk-free rate. In the short-horizon calculation, SBWGE used 1-year Treasury bill yield of 2.70% to represent the risk-free rate. The long, intermediate, and short-horizon expected equity risk premia of 7.4%, 7.8%, and 8.8%, respectively, were taken from Ibbotson Associates SBBI. SBWGE's expected return on equity estimates using the risk premium model range from 11.50% to 13.10% and average 12.45%. (SBWGE initial brief at 34)

Mr. Bacalao averaged the results of his CAPM, DCF and Risk Premium models to produce a cost of equity estimate of 12.41%. The Company says that by averaging the results of all five models, Mr. Bacalao's second cost equity estimate of 13.02% was produced. The Company states that these two estimates serve as the lower and upper range for the cost of equity with a mid-point of 12.71%, which Mr. Bacalao recommended for both SBWGE's gas and water operations.

2. Staff's Recommendation

Staff witness Ms. Freetly measured the investor-required rate of return on common equity for SBWGE's gas and water operations using the discounted cash flow and risk premium models. Staff states that since SBWGE does not have market-traded common stock, DCF and risk premium models cannot be applied directly to SBWGE; therefore, Ms. Freetly applied both models to samples of natural gas distribution companies, water utilities, and public utilities deemed comparable in risk to SBGWE's corporate parent, WPL. (Staff initial brief at 36)

Ms. Freetly's gas sample comprises nine dividend-paying, market-traded gas utilities from the Standard & Poor's Utility Compustat database that had S&P credit ratings of AA to A-; S&P business profile scores of 2, 3, or 4; and long-term growth rate estimates from Zacks Investment Research ("Zacks") or Institutional Brokers Estimate System ("IBES"). Staff states that Ms. Freetly's water sample comprises seven dividend-paying, market-traded water utilities within the S&P Utility Compustat database that had long-term growth rate estimates from Zacks or IBES. According to Staff, the utility sample comprises eight dividend-paying, market-traded utilities within the S&P Utility Compustat database that had a S&P business profile score of 3; S&P credit ratings of AA to A-; and long-term growth rate estimates from Zacks or IBES. (Staff initial brief at 36)

Staff states that Ms. Freetly limited the gas sample to gas utilities with S&P business profile scores of 2, 3, or 4 because there were only two gas utilities in S&P Utility Compustat with business profile scores above 4. Staff asserts that Energen Corp. and National Fuel Gas Company both have business profile scores of 6 due to considerable investments in riskier non-regulated exploration and production subsidiaries. Staff states that these companies were excluded from the sample so that the sample reflected the risk inherent in the regulated gas utility business. (Staff initial brief at 40, citing Staff Ex.10.0 at 9)

According to Staff, the purpose of the gas sample is to estimate the cost of equity of the gas operations of SBWGE. Staff believes that since the average business profile score for gas utilities is 3, an average business profile of 3 for the gas sample is reasonable. Staff says that in forming the water sample, Ms. Freetly used the available universe of publicly traded water utilities. Staff also states that the companies in the utility sample were limited to those with S&P business profile scores of 3 because that is the average business profile score of the water utility industry, which is exposed to the same sources of operating risk as the water utility operations of SBWGE. (Staff initial brief at 40-41, citing Staff Ex. 10.0 at 9)

It is Staff's position that although some industrial companies may be similar in risk to SBWGE, identifying such companies is problematic because SBWGE does not have publicly traded common equity; hence, investment advisory services such as Value Line do not evaluate the risk of its common equity. In addition, Staff claims it does not have access to data that would enable it to quantitatively measure the risk of industrial companies. Staff asserts that limiting samples to companies in the same industry assures a degree of comparability in business risk that is not attainable with industrial companies given the tools at hand. (Staff initial brief at 41)

According to Staff, S&P's business profile scores, which also measure business risk, enabled Staff to refine the comparability of the gas sample's and utility sample's business risk to that inherent in SBWGE's gas and water operations, respectively. Staff asserts that credit ratings enabled Staff to identify companies with similar financial strength, and hence, financial risk, to SBWGE. (Staff initial brief at 41)

As indicated above, Ms. Freetly applied DCF and risk premium models to the samples of companies that she developed. Ms. Freetly states that according to DCF theory, a security price equals the present value of the cash flow investors expect it to generate. That is, the market price of common stock equals the cumulative value of the expected stream of future dividends after each is discounted by the investor-required rate of return. Effectively, Ms. Freetly rearranged the DCF model so that the investor-required rate of return on common equity was the dependent variable, the market price of common stock and expected growth rates were the independent variables. (Staff Ex. 4.0 at 15-16)

The simplified DCF model may be expressed as follows:

$$k = d_1/P_0 + g$$

where: k is the investor required rate of return, d_1 is the current dividend, P_0 is the market price of common stock and g is the expected growth rate.

Because the companies in Ms. Freetly's samples pay dividends quarterly, she applied a constant-growth quarterly DCF model. Staff states that determining the market-required rate of return with the DCF methodology requires a growth rate that reflects the expectations of investors and that Ms. Freetly measured the market-consensus expected growth rates with projections published by Zacks and IBES. Staff says the growth rate estimates were combined with the closing stock prices and dividend data as of February 3, 2004. Based on this growth, stock price, and dividend data, Ms. Freetly's DCF estimates of the cost of common equity were 9.40% for the gas sample, 9.78% for the water sample, and 8.98% for the utility sample. (Staff initial brief at 37)

Staff states that the risk premium model is based on the theory that the market-required rate of return for a given security equals the risk-free rate of return plus a risk premium associated with that security. Staff says the risk premium methodology is consistent with the theory that investors are risk-averse. According to Staff, in equilibrium, two securities with equal quantities of risk have equal required rates of return. Ms. Freetly used the CAPM, a one-factor risk premium model, to estimate the cost of common equity. Staff states that in the CAPM, the risk factor is market risk, which is defined as risk that cannot be eliminated through portfolio diversification. (Staff initial brief at 37)

The CAPM mathematically depicts the relationship between risk and return as:

$$R_j = R_f + B_j \times (R_m - R_f)$$

where: R_j = the required rate of return for security j; R_f = the risk free rate; R_m = the expected rate of return for the market portfolio; and B_j = the measure of market risk for security j.

According to Staff, Ms. Freetly considered two current estimates of the risk-free rate of return: the 0.94% yield on three-month U.S. Treasury bills and the 5.12% yield on thirty-year U.S. Treasury bonds. Staff states that because forecasts of inflation and real GDP imply that the long-term risk-free rate is between 5.7% and 6.0%, Ms. Freetly concluded that the thirty-year U.S. Treasury bond yield is currently the superior proxy for the long-term risk-free rate. (Staff initial brief at 37- 38, citing Staff Ex. 4.0 at 21-26)

Staff indicates that Ms. Freetly developed two distinct sample average betas for each sample, one based on the Value Line methodology ("Value Line beta") and the other based on the Merrill Lynch methodology ("Regression beta"). Staff indicates that the Value Line beta estimates average 0.73 for the gas sample, 0.59 for the water sample, and 0.72 for the utility sample while the Regression beta estimates are 0.50 for the gas sample, 0.42 for the water sample, and 0.53 for the utility sample. Staff states that the average of the Value Line and Regression beta estimates equals 0.62 for the gas sample, 0.51 for the water sample and 0.63 for the utility sample. (Staff initial brief at 38)

Ms. Freetly estimated a 13.50% expected rate of return on the market by conducting a DCF analysis on the firms composing the S&P 500 Index. Inputting Ms. Freetly's risk-free rate, return on the market, and beta estimates into the CAPM, produces cost of common equity estimates of 10.32% for the gas sample, 9.40% for the water sample, and 10.40% for the utility sample. (Staff initial brief at 38, citing Staff Ex. 4.0, Schedule 4.09)

Based on the results of her DCF and risk premium analyses, Ms. Freetly estimated that the cost of common equity for SBWGE equals 9.87% for the gas operations. Staff states that the average investor required rate of return on common equity for the gas operations of SBWGE, 9.87%, is based on the average of the DCF-derived results (9.40%) and the risk premium-derived results (10.32%) for the gas sample. (Staff initial brief at 39)

Staff's recommended return on common equity for the water operations of SBWGE was derived by: 1) averaging Staff's DCF-derived estimates of the required rate of return on common equity for the water (9.78%) and utility (8.98%) samples, or 9.38%, 2) averaging Staff's risk premium-derived estimates of the required rate of return on common equity for the water (9.40%) and utility (10.40%) samples, or 9.90%, and 3) taking the midpoint of the DCF and risk premium derived estimates, or 9.64%. Thus, Staff recommends that the Commission authorize a 9.64% return on common equity for SBWGE's water operations. (Staff initial brief at 39)

According to Staff, Ms. Freetly used the average of the water and utility samples to estimate the cost of common equity for the water operations of SBWGE in order to attain a greater degree of comparability. Staff asserts that the S&P credit ratings, business profile scores, and the S&P benchmark ratios for each of the samples in comparison to WPL show that the three-year average benchmark ratios for the gas sample are the most similar to WPL. Staff also contends that the three-year average benchmark ratios for the water sample are the least comparable to WPL and that the three-year average benchmark ratios for the utility sample are more comparable to WPL than the water sample. (Staff initial brief at 39)

Staff argues that it is appropriate to use the utility sample in conjunction with the water sample to estimate the cost of equity for the water operations of SBWGE to more closely simulate the risk of WPL. Staff claims that since she was estimating the cost of equity for the water operations of SBWGE, Ms. Freetly retained the water sample because it captures industry-level operating risks associated with the provision of water service. Staff asserts that it was not necessary to use the utility sample in combination with the gas sample, since the three-year average benchmark ratios for the gas sample were more comparable to WPL than the utility sample and better reflected the risk of WPL. (Staff initial brief at 39-40, citing Staff Ex. 4.0 at 34)

3. Staff Comments on the Company's Analysis

Staff claims that the sample used by SBWGE in its cost of equity analysis is not representative of the risk inherent in the Company's gas and water operations. Staff criticizes the use of Value Line safety ranking as an imprecise measure of risk, asserting that stocks with different assigned safety numbers may be more similar in risk than stocks ranked far apart with identical assigned safety numbers. Staff also asserts that Alliant Energy's safety rank reflects non-utility risks since Alliant's Energy's non-regulated subsidiary, Alliant Energy Resources Inc. ("Resources"), operates international distribution and generation and U.S. generation businesses. Staff argues that calculating the cost of equity estimate from a sample based on Alliant Energy's safety rank would reflect the risk of the unregulated affiliate, Resources. (Staff initial brief at 25, reply brief at 9-10)

Staff also criticizes SBWGE for using WPL's current S&P corporate credit rating of A- in selecting its sample. Staff asserts that WPL's credit rating was downgraded to A- due to Alliant Energy's non-utility investments. (Staff initial brief at 25-27; Staff Ex. 4.0 at 9) Staff believes SBWGE's cost of common equity analysis is not in compliance with the requirements of Section 9-230 of the Act as discussed further below. (Staff initial brief at 25-27, reply brief at 9-10)

Staff also takes issue with the various models used by the Company to estimate cost of equity, including the comparable earnings analysis. According to Staff, the cost of common equity is the market-required rate of return demanded by investors. Staff argues that in contrast, comparable earnings analysis is an accounting return-based methodology rather than a market-based methodology. Staff asserts that the comparable earnings method incorrectly implies that the earned or expected rates of return on book common equity are equivalent to the current investor-required rate of return. Staff believes that market-based cost of equity methodologies reflect the investor-required rate of return since the market price of a common stock will not reach equilibrium until the expected rate of return on the common stock equals the investor-required rate of return. Staff claims the return on book equity has no such adjustment mechanism since its denominator, book value, is largely unresponsive to market forces. (Staff initial brief at 27-28)

Staff contends that SBWGE's risk premium model is based on the incorrect assumption that historical risk premiums are reasonable estimates of current investor-required risk premiums. Staff claims that historical risk premiums do not adequately measure investors' current return requirements because historical risk premiums are based on realized returns. It is Staff's position that due to unpredictable movements in financial markets and the economy, the difference between realized and expected returns can be substantial; thus, historical premiums are not reliable proxies for current or future risk premiums. (Staff initial brief at 30, citing Staff Ex. 4.0 at 41)

Staff is also critical of how SBWGE implemented the CAPM. Specifically, Staff objects to the modification of beta to account for the effect of a company's financial leverage on its risk. Staff argues that re-levering the betas of SBWGE's sample companies to SBWGE's financial leverage increases the implied risk of the Company's sample relative to SBWGE. According to Staff, if the total risk of SBWGE's sample was equal to that of SBWGE, then the beta adjustment resulted in a sample with implied total risk greater than that for SBWGE. (Staff initial brief at 32-33, reply brief at 10)

Staff also takes issue with the two-stage DCF analysis presented by SBWGE, and its use of an estimate of the historical nominal growth in gross domestic product ("GDP") to develop its 7.979% terminal growth rate. Staff argues that rather than relying on historical earnings data to determine the forward-looking cost of equity, an estimate of expected long-term economic growth should be used. In addition, Staff contends that the Company's terminal growth rate is excessive when compared to the yields of U.S. Treasury bonds, which Staff suggests should be higher than the terminal growth rate. (Staff initial brief at 33-34)

Staff also objects to the Company's use of a single terminal growth rate. Staff states that this rate implicitly assumes all utilities will grow at the same rate as the economy and pay out the same proportion of earnings as dividends. Staff suggests that due to the maturity of the utility industry and the higher dividend payout of utility companies, utilities will not grow at the same rate as the economy. It is Staff's position that given the lower growth rates and higher dividend yields of utilities, it is not reasonable to assume that all of the sample companies will grow at the 7.979% rate, as assumed by Mr. Bacalao. (Staff initial brief at 34-35, citing Staff Ex. 10.0 at 13-15)

4. SBWGE Response to Staff's Analysis and to Staff's Criticisms

SBWGE was critical of Staff's cost of equity analysis. The Company complains that Staff did not include any analysis of the economic, market or regulatory risks impacting SBWGE or its parent WPL. (SBWGE initial brief at 35-36)

SBWGE also objects to the proxy samples used by Staff, complaining that Staff fails to recognize that WPL is more susceptible to adverse effects of changes in circumstances and economic conditions than those companies with higher credit ratings. Specifically, SBWGE suggests that Staff's use of firms with a credit rating higher than "A" is inappropriate. (SBWGE initial brief at 36-37) SBWGE claims that Staff arbitrarily attributed an AA- and an A+ credit rating to WPL and created a proxy group of companies with an intrinsically lower risk profile than WPL. (SBWGE initial brief at 39-40)

SBWGE asserts that Staff's risk metrics are all derived from credit risk analysis, without any attempt to measure equity risk in the selection process. According to SBWGE, credit and equity risk are different concepts, measuring financial risk to distinctly different sets of investors. SBWGE argues that this fact makes the validity of Staff's sample suspect. It is SBWGE's position that Value Line provides the best measure for equity risk measurement because it examines the stock risk, i.e. equity risk. (SBWGE reply brief at 11-12)

SBWGE maintains that the companies in Staff's proxy group were not comparable to SBWGE but instead were much less risky. SBWGE claims that the long-term debt ratio of each of the sample companies was lower than SBWGE's debt ratio. SBWGE asserts that the average financial strength of the sample companies was better than SBWGE's financial strength. Additionally, SBWGE contends that the average business risk for Staff's proxy group was 3, while SBWGE's business risk is 4.

SBWGE also disagrees with Staff's reliance on the requirements of Section 9-230 of the Act in its cost of common equity analysis. SBWGE argues that WPL's credit rating downgrade is not linked solely to its affiliation with its parent company, Alliant Energy Corporation. SBWGE contends that Staff cannot establish how much WPL's cost of capital has increased due to its affiliation with Alliant Energy because Alliant Energy has not manipulated SBWGE's and WPL's capital structure. According to SBWGE, this is the standard the Commission must apply when determining if a company is burdened with incremental risk or increased cost of capital directly attributable to an affiliation with a non-regulated entity. (SBWGE initial brief at 37-38, citing *Illinois Bell Telephone Company v. Illinois Commerce Commission*, 283 Ill App. 3d. 188; 669 N.E. 2d 919, 935; 218 Ill. Dec. 598, (Illinois Second District 1996) ("*Illinois Bell*"))

SBWGE claims that in evaluating compliance with Section 9-230 of the Act, the Commission must determine if the company is burdened with any incremental risk or increased cost of capital directly attributable to an affiliation with a non-regulated entity. SBWGE says the Commission next must find that the capital structure has not been consciously manipulated. The Company asserts that if the Commission does find the cost of capital has increased because of its affiliation with a non-regulated subsidiary, the Commission must determine the amount of this increase. It is SBWGE's position that absent a showing of any of the above, a violation of Section 9-230 has not occurred. The Company contends that there is no evidence that WPL's cost of capital has increased due to its affiliation with Alliant Energy. (SBWGE initial brief at 37-38)

According to SBWGE, if Staff had performed the additional analysis regarding risks and employed other models, Staff would have obtained insights into a number of questions, including why Staff's water sample ranks highest in one model and lowest in the other, while the utility sample flips from lowest to highest in those same models. (SBWGE brief at 40) SBWGE also suggests Staff's analysis is problematic because the Commission has consistently allowed a higher return on common equity for the gas segment of a utility's operation than the electric segment. (SBWGE initial brief at 41)

SBWGE also criticizes Staff for using only the single stage DCF model and the CAPM in its cost of common equity analysis. SBWGE also suggests that use of additional models would have allows Staff to compensate for the limitations, weaknesses and statistical bias in Staff's analysis. (SBWGE initial brief at 38-41)

SBWGE also responds to Staff's criticisms of the Company's analysis. In its reply brief, SBWGE defends its proxy sample, claiming it employed a larger proxy group that more accurately reflected the inherent business risks of its parent, WPL. SBWGE claims its larger sample of proxy companies is more reflective of actual market conditions and dynamics. SBWGE says it is important to keep in mind that a proxy group by definition will never reflect all the attributes of any given company, since no two companies are identical. SBWGE asserts that its sample more closely resembles the actual universe of alternatives investors consider in making an equity investment decision for a company such as SBWGE, or WPL. (SBWGE reply brief at 9-10)

SBWGE defends including companies in its sample from outside the utility industry. SBWGE suggests that an investor is not limited to purchasing utility stock, and therefore, an investor has a choice in choosing the stock that it buys. According to SBWGE, the Commission should recognize that since investors are not limited to utility stocks, it is reasonable to include other industries in a proxy group. SBWGE argues that not only does it accurately reflect the choices investors are faced with, but the proxy group also includes a larger sample that makes the model more statistically valid. SBWGE further claims that the size and constrained scope of Staff's sample groups undermine the statistical validity of Staff's analysis and conclusions and that it cannot reasonably estimate investor-required return on equity because it fails to replicate the investment choices investors face. (SBWGE reply brief at 10-11)

Also in its reply brief, SBWGE asserts that the single stage DCF model requires the analyst to make certain strong assumptions in order to make this "simplified" model work. The Company claims that the single stage DCF model has the effect of reducing the universe of companies that can be included in the sample. SBWGE presented other criticisms of the single stage DCF model in its reply brief. (SBWGE reply brief at 13-14)

SBWGE argues that Staff has not presented any evidence that a reasonable investor would not rely on the long-term growth rates presented by the Company. The Company also disputes Staff's claim that that forecasts of inflation and real GDP imply the long-term risk-free rate is between 5.7% and 6.0%. SBWGE contends that Staff's assertion is unsupported because there is no demonstrated causal link between the long-term risk-free interest rate and real GDP. (SBWGE reply brief at 14-15)

In response to Staff's criticism of the beta calculations in the Company's CAPM analysis, SBWGE argues that the objective in making the beta adjustments is to make the sample group results consistent. SBWGE asserts that the companies in a sample that are otherwise comparable, except for their financial leverage, do not face the same investor-required cost of equity. The Company claims that to compensate for these differences before estimating the cost of equity, SBWGE undertook the adjustments in the beta value, so that the sample's leverage was equivalent to WPL's, and the cost of equity estimates would be comparable. (SBWGE reply brief at 15-16)

In its reply brief, SBWGE defends its use of historical data. SBWGE asserts that historical information holds great value when used in combination with more recent data. The Company contends that the combined use of five methods allows the benefit of canceling out offsetting biases, to the degree they exist. (SBWGE reply brief at 16)

5. Staff Reply to Company Criticisms

Staff claims that it did not rely solely on debt credit ratings as a measure of equity investment risk. Staff contends that it relied on S&P credit ratings and business profile scores when selecting companies to serve as proxies for SBWGE. Staff says the credit ratings represent the financial risk of the companies to which they are assigned, whereas the business profile scores represent the business risk to which those companies are exposed. Staff argues that its sample selection methodology is based on the total risk of the gas and water utility operations of SBWGE. (Staff reply brief at 11)

In response to criticism of its sample, Staff contends that WPL's business profile score, 4, reflects the total business risk of WPL as a provider of electric, gas, and steam services. It is Staff's position that a business profile score of 3 is more representative of the average business profile score of gas and water utilities. According to Staff, in most instances S&P categorizes pure gas distribution companies as having well-above-average ('2') or above-average ('3') business profiles on a ten-point scale ('10' equals high risk, while '1' equals low risk). Staff states that the business risk scores of water utilities are generally either '2' or '3'. Staff believes since the objective was to estimate the cost of equity for the gas and water operations of SBWGE, sample groups with average business profile scores of 3 adequately represent the level of business risk inherent in those industries. (Staff reply brief at 11-12)

In response to the Company's assertion that the Commission has consistently allowed a higher cost of common equity for the gas segment of a utility's operation than the electric segment. Staff avers that the Orders cited are distinguishable and do not establish a consistent Commission policy for allowing higher costs of common equity for gas than electric operations. Staff claims that since the cost of equity is estimated by relying on market information, the timing and risk characteristics of particular company operations greatly impact cost of equity estimates. (Staff reply brief at 12)

It is Staff's position that SBWGE's interpretation of *Illinois Bell* is flawed. According to Staff, *Illinois Bell* did not address the issue of when Section 9-230 is applied. Staff argues that Section 9-230 on its face applies "in any proceeding to establish rates or charges . . . ." According to Staff, SBWGE's "three steps" do not correctly set forth the Section 9-230 analysis required by *Illinois Bell*. (Staff reply brief at 13-14)

According to Staff, under *Illinois Bell* the Commission has to determine if the utility is burdened with any incremental risk or increased cost of capital because of its affiliation with unregulated or non-utility companies. Staff contends that the issue is whether the utility's affiliation with the unregulated or non-utility companies has "in any way, regardless of mental state of the actors involved, caused [the utility's] risk or capital costs to increase." (Staff reply brief at 14-15, citing *Illinois Bell* at 210)

Staff claims that SBWGE misunderstands this part of the analysis by claiming the Commission must find that the capital structure has not been consciously manipulated. According to Staff, *Illinois Bell* was clear that "a finding that [a utility's] capital structure has not been consciously manipulated, with nothing more, will not satisfy section 9-230's requirements." (Staff reply brief at 15, citing *Illinois Bell* at 210)

According to Staff, SBWGE confuses the specific allegation in *Illinois Bell* (i.e., that its affiliation with nonutility companies led to a manipulated capital structure) with the broader scope of Section 9-230 set forth in *Illinois Bell* to not include any increase in a utility's cost of capital resulting from affiliation with unregulated or non-utility companies. Staff claims that the final part of the Section 9-230 analysis is ". . . if [the utility's] incremental risk or cost of capital has increased because of its affiliation with [unregulated or nonutility companies], the Commission must determine the amount of the increase. Any increase then must be removed from the calculation of [the utility's] ROR." (Staff reply brief at 15-16, citing *Illinois Bell* at 210)

It is Staff's position that the downgrade to WPL was due to Alliant Energy's non-regulated activities. Staff claims its analysis is consistent with *Illinois Bell*. In Staff's view, if the Commission were to adopt SBWGE's "three step" analysis it would be contradictory to the requirements of Section 9-230 as required by *Illinois Bell*. (Staff reply brief at 16)

6. Commission's Analysis and Conclusions

The Commission has reviewed the testimony and briefs regarding cost of common equity and it is clear that there are many areas of disagreement among the parties. After developing "comparable" samples of companies and applying DCF and CAPM models (among others) to those samples, the Company estimates cost of equity to be 12.71% for both gas and water operations, while Staff recommends a return on equity of 9.87% for gas operations and 9.64% for water operations. The main areas of disagreement are over the selection of comparable samples, and the appropriate inputs in and versions of the analytical models applied to those samples. The positions of the parties on these issues are well explained in their testimony and briefs, are summarized above and will not be repeated in detail here.

The Commission will begin its analysis with the selection of **comparable samples**. As both SBWGE and Staff point out, the common stock of the Company is not publicly traded and it is, therefore, not possible to directly measure the cost of common equity of SBWGE. In the Commission's view, the primary objective in developing a comparable sample is to identify a group or groups of firms that are similar in total risk to the target, SBWGE's water and gas operations. By total risk, the Commission means financial and operating risk.

As explained more fully above, in developing its samples, the Company started by looking at all the companies followed by the Value Line Investment Survey, while Staff limited its samples to utility companies. While it is certainly possible for firms outside the utility industry to have total risk similar to that of SBWGE's water and gas operations, in the Commission's view, all else equal, there is a tendency for firms in similar industries to have similar risk. The Commission agrees with Staff that when choosing a comparable sample, there should be more emphasis on identifying firms that are similar in total risk to SBWGE's water and gas operations than on considering the wide array of options available to investors. The wide array of investment alternatives to which SBWGE alludes include investments with widely divergent risks and, therefore, widely divergent required returns. In the Commission's view, caution must be exercised when including firms outside of regulated industries in comparable samples.

In its filings, the Company takes issue with of statistical validity of Staff's samples. While the Commission agrees that the statistical validity of the analysis is a consideration, the Commission observes that there is no quantitative analysis in the record demonstrating a problem with the statistical validity of Staff's samples. Based on the record in this proceeding, the Commission believes that emphasizing comparability of the firms in the sample, and relying on the smaller universe of companies in regulated industries, as Staff has done in its analysis, achieves the proper balance.

Furthermore, because firms quite similar in risk can be assigned different Safety Ranks while firms less similar in risk can be assigned the same Safety Rank, the Value Line Safety Rank used by the Company may be viewed as a somewhat imprecise measure of the risk inherent in the Company's gas and water operations.

Even if Safety Rank were used as an indicator of operating risk, the Commission disagrees with the use of Alliant Energy's Safety Rank of 2 as the benchmark in selecting comparable firms. As discussed in more detail below, the Commission agrees with contentions by Staff that the non-utility operations of Alliant Energy and its affiliates have caused an increase in the operating risk of Alliant Energy. Similarly, the Commission has concerns about the A- credit rating benchmark used by SBWGE as a screening tool. As discussed below, the Commission believes that the credit rating of WPL has been adversely impacted by its affiliation with Alliant Energy.

In criticizing Staff's comparable samples, SBWGE also argues that credit and equity risks are different concepts that involve measuring financial risk to different sets of investors. The Commission does not fully understand SBWGE's argument because it seems clear that investing in the debt securities of a given firm involves different risks than investing in that firm's common equity. Nevertheless, as discussed previously, the Commission believes it is important to focus on identifying firms that are similar in risk to the target firm and Staff's analysis is the more appropriate in that regard.

The Commission also believes that SBWGE is incorrect in arguing that Staff considered only credit risk when developing its comparable samples. The record shows that Staff also used the S&P business profile score in selecting comparable firms. The Commission finds that the S&P business profile score is assigned in a manner that fairly assesses the operating risk of firms. Thus, the S&P business profile score may reasonably be used as a tool in developing a comparable sample.

Having found that the S&P business profile score may be used in developing a comparable sample, the Commission turns to the specific business scores used in this case. In selecting its gas sample, Staff included gas utilities with an S&P business score of 2, 3, or 4. In selecting its utility sample, Staff included utilities with a business score of 3.

SBWGE complains that Staff used an average S&P business score of 3 while WPL's business score is 4 and, therefore, produces a sample that is less risky than WPL. The Commission notes, however, that the ultimate objective here is to estimate the cost of common equity for SBWGE's water and gas operations, not for WPL's operations. As indicated by Staff, WPL's business profile score of 4 reflects the total business risk of WPL as a provider of electric, gas, and steam services, and it is Staff's position that a business profile score of 3 is more representative of the average business profile score of gas and water utilities. It appears to the Commission that Staff has attempted to balance the competing objectives of developing samples with a reasonable number of firms and samples that contain firms most similar in risk to the target firms. The Commission finds Staff's rationale, which considered the operating risk associated with each type of utility operation, to be reasonable.

With respect to the requirements of Section 9-230 of the Act and the *Illinois Bell* decision, the parties' positions are summarized above. In the Commission's view, the record establishes that the credit rating of WPL has been revised downward as a result of its affiliation with Alliant Energy and Alliant Energy's higher risk, non-regulated business activities. (Staff Ex. 4.0 at 9-10) The suggestion that the Commission can rely upon WPL's existing credit rating in determining the cost of capital associated with SBWGE's water and gas operations is in conflict with Section 9-230 of the Act.

Section 9-230 requires that "in determining a reasonable rate of return upon investment for a public utility in any proceeding to establish rates or charges, the Commission shall not include any incremental increase in risk or cost of capital which is the direct or indirect result of the public utility's affiliation with unregulated or nonutility companies." The Commission agrees with Staff that Section 9-230 and the *Illinois Bell* decision require that any such increase be removed from the calculation of the utility's rate of return. In fact, that is the point of Section 9-230. To the extent the Company is suggesting that no adjustment under Section 9-230 is appropriate absent a finding of conscious manipulation of the capital structure, such an argument is contrary to the plain language of Section 9-230 and the decision in *Illinois Bell*. In that decision, as noted by Staff, the Court reasoned that "a finding that [a utility's] capital structure has not been consciously manipulated, with nothing more, will not satisfy section 9-230's requirements." (Staff reply brief at 15, citing *Illinois Bell* at 210) In the instant case, the Commission finds that the analysis performed by Staff represents a reasonable way to quantify and remove the incremental risk and cost associated with the affiliation.

With regard to sample selection, the Commission also observes that in this proceeding it must determine SBWGE's cost of capital, not WPL's. While WPL is the parent of SBWGE, the use of WPL in any way is nothing more than a proxy for SBWGE.

In conclusion, in comparing the two proposals in the record for selecting comparable samples, the Commission finds that Staff's approach, including its use of screening tools and its interpretation and application of Section 9-230 requirements, produces samples more similar in total risk to SBWGE's gas and water operations and should be utilized in estimating cost of equity in this proceeding.

As indicated above, after developing comparable samples of companies, Staff and the Company applied various **analytical models for estimating cost of equity**, including the DCF and CAPM models, to those samples.

Both SBWGE and Staff performed discounted cash flow or "DCF" analyses to estimate the cost of common equity. Here the principle difference between the two is whether a single-stage or two-stage DCF model should be implemented and correspondingly, what growth rates should be used. For the terminal or second stage growth rate, the Company used historical nominal growth in gross domestic product, 7.979%. Staff on the other hand, used analyst forecasts of earnings growth in its single stage DCF model.

The Commission shares Staff's concerns as to whether historical data can reasonably be relied upon to estimate future growth in earnings used to estimate a forward-looking cost of common equity. Evidence presented by Staff, including that forecasted long-term nominal GDP growth is approximately 6.0%, lends support to the Commission's view that the forecasts used by Staff, rather than the historic data used by the Company, should be used as a proxy for future expectations in this instance. The Commission notes that the average growth rates used by Staff vary somewhat among the individual companies in Staff's samples. Nevertheless, when viewed in its entirety, the forward-looking nominal GDP growth rate seems to support Staff's growth rates rather than the Company's terminal growth rate.

The Commission is also concerned with the implication of SBWGE's recommendation that the long-term earnings growth rate for all utilities is almost 8.0% per year. In estimating the cost of common equity, when possible the Commission prefers to utilize company-specific information. While there may be occasions when the use of a multi-stage DCF model is appropriate, the record in this case does not indicate that either general economic conditions, company specific circumstances or other factors support use of a multi-stage DCF model over the single-stage DCF model and company specific long-term growth rates.

Of the two proposals in the record, the Commission concludes that the DCF approach employed by Staff is the more reasonable for use in estimating the Company's cost of equity in this proceeding.

As explained above, both SBWGE and Staff also used the capital asset pricing model or "CAPM" to develop estimates of the cost of common equity. In the Commission's view, the approach used by the Staff is the more reasonable of the two. The principle dispute among the Company and Staff is whether the betas should be un-levered and then re-levered. SBWGE advocates this levering process and Staff opposes it. SBWGE appears to be suggesting that the levering process is necessary because the companies in the sample have different leverage than WPL. In the Commission's view, as contended by Staff, the levering process proposed by the SBWGE is unnecessary if the comparable sample has total risk that is similar to that of the target Company.

Even assuming a levering process should be considered in this proceeding, the Commission believes the levering process employed by SBWGE is problematic. According to SBWGE, to implement its levering process, the book equity of Alliant Energy Corporation and WPL, in connection with the market to book equity ratio of Alliant Energy Corporation equity, were used to calculate an approximate equity market capitalization for WPL since WPL does not have a publicly traded stock. Rather than producing a CAPM result that is reflective of the risk of SBWGE's water and gas operations, it appears that the Company's process would produce a result with greater risk than WPL.

Next, the Commission will briefly address the other three cost of equity estimation models presented by the Company. With regard to the second risk premium analysis utilized by SBWGE, the Commission notes that the Company relied exclusively on historic data to develop its three risk premia, those being short-term, intermediate and long-term. As argued by Staff, there has been no showing in this record that a historical risk premium provides an indication of what a forward-looking risk premium might be. Additionally, the risk premium analysis presented by the Company appears to suggest that all companies, regardless of their individual risk profiles, have the same cost of common equity.

With respect to SBWGE's historical return on equity "model," the Commission agrees with Staff that this analysis contains no forward-looking information at all and provides little insight into what return investors might demand in the future.

SBWGE's forecasted return on book common equity model is also known as a comparable earnings analysis. This approach to estimating cost of common equity has been presented by witnesses in various ratemaking proceedings over the last several years. The Commission finds, as it has in prior dockets, that the comparable earning approach has little value because it constitutes an accounting return-based approach rather than a market-based methodology, and fails to reflect the investor-required rate of return.

Of the two proposals in the record, the Commission concludes that the DCF and CAPM models utilized by Staff for estimating cost of equity are the more appropriate for use in this proceeding, and were properly applied by Staff.

Having reviewed the entire record and based upon the conclusions above, the Commission finds that the comparable samples and the cost of common equity analyses presented by Staff will provide a better estimate of SBWGE's costs of common equity than those developed and presented by SBWGE. As a result, the Commission must next determine how the results of Staff's analyses should be used to produce estimated costs of common equity for SBWGE's water and gas operations.

Staff's recommended rate of return on common equity for SBWGE's gas operations, 9.87%, is based on the average of the DCF-derived results (9.40%) and the risk premium-derived results (10.32%) for the gas sample. For SBWGE's water operations, Staff averaged the DCF estimates of return on common equity for the water (9.78%) and utility (8.98%) samples; averaged the risk premium estimates for the water (9.40%) and utility (10.40%) samples; and took the midpoint of those averages, producing a 9.64% estimate of the cost of common equity.

Staff asserts that its gas sample is most similar in risk to WPL, that its utility sample is next most similar in risk to WPL and that its water sample is least similar of the three in risk to WPL. After reviewing Staff Ex. 4.0, Schedules 4.08, 4.09 and 4.10 as well as Ms. Freetly's explanation of how she reached her conclusions, the Commission finds her recommendations to be reasonable. While mindful that the objective here is to estimate the cost of common equity for SBWGE's gas and water operations, the Commission agrees that comparisons to WPL have value toward that end.

In this instance, the Commission finds it reasonable to rely solely on the gas sample in estimating the cost of equity for SBWGE's gas operations. Additionally, the Commission believes combining the results of the analyses on the water and utility samples produces the best estimate of cost of equity for SBWGE's water operations. Finally, while the Company took issue with Staff's analysis in this regard, the Commission observes that adding the utility sample results to the gas sample results would actually have produced lower cost of equity results, as would excluding the utility sample results from the water cost of common equity computation.

The Commission concludes that the authorized rate of return on common equity for SBWGE's gas operations should be 9.87%. The Commission further concludes that the authorized rate of return on common equity for SBWGE's water operations should be 9.64%.

D. Approved Capital Structure and Cost of Capital

Upon giving effect to the conclusions contained above, SBWGE's capital structure and costs of capital, resulting in overall costs of capital and authorized rates of return on rate base of 8.41% for gas operations and 8.29% for water operations, may be summarized as follows:

Gas Operations

Component	Amount	Percentage	Cost Rate	Weighted Cost
Short-term Debt	$33,164,078	2.58%	1.00%	0.03%
Long-term Debt	$509,794,069	39.73%	7.30%	2.90%
Preferred Stock	$60,218,000	4.69%	5.50%	0.26%
Common Equity	$680,073,615	53.00%	9.87%	5.23%
Total	$1,283,249,762	100.00%		8.41%

Water Operations

Component	Amount	Percentage	Cost Rate	Weighted Cost
Short-term Debt	$33,164,078	2.58%	1.00%	0.03%
Long-term Debt	$509,794,069	39.73%	7.30%	2.90%
Preferred Stock	$60,218,000	4.69%	5.50%	0.26%
Common Equity	$680,073,615	53.00%	9.64%	5.11%

Total	$1,283,249,762	100.00%	8.29%

VII. COST OF SERVICE AND RATE DESIGN

A. Introduction

SBWGE prepared and presented cost of service studies ("COSS") for both its gas and water operations in the proceeding. Generally, a COSS is performed to assist in allocating costs among all customer classes by determining the responsibility for the costs imposed on the utility by each specific customer class. Rates can then be designed to reflect the cost to serve each customer class.

SBWGE and Staff agree on most issues regarding rate design, and tariff terms and conditions, in this proceeding. SBWGE has agreed to make changes to its rate design and tariffs for its gas and water operations as recommended by Staff except for Staff witness Harden's recommendation regarding SBWGE's gas rate class Gg-2, as discussed further below.

B. Water Service

Mr. Larry White performed a COSS for SBWGE's water operations and Staff did not object to SBWGE's COSS. SBWGE and Staff reached agreement on the approach that should be used to design the customer and usage charges for all customer classes.

During the hearing, Staff witness Marr testified that there are no remaining disputes between Staff and SBWGE regarding the specific issues raised in his testimony. (Tr. 167) Those issues include SBWGE's proposed Final Water Tariff, and SBWGE's "Free Limit" definition, which now complies with the current provisions of the Commissions' regulations at 83 Ill. Adm. Code 600.370(b)(2). In his rebuttal testimony, Mr. Marr recommended that SBWGE make additional changes and SBWGE made those changes. (Staff initial brief at 50-51)

As indicated above, the Company seeks authorization to implement a surcharge to recover water supply costs pursuant to 83 Ill. Adm. Code 655. Staff agrees that a purchased water surcharge rider is appropriate for SBWGE and that the rider should be approved. (Staff initial brief at 52) Staff witness Smith noted, however, that the rates to be charged for water purchased by SBWGE from the City of Beloit, Wisconsin will be regulated by the State of Wisconsin. Mr. Smith stated, therefore, that in the annual reconciliations before the Illinois Commerce Commission, the prudence of water purchases should be reviewed, including a review of public information available relative to rate setting and other proceedings before the Public Service Commission of Wisconsin. (Staff initial brief at 52, citing Staff Ex. 3.0 at 3-8)

For the reasons given by the parties, the Commission agrees that a purchased water surcharge rider is appropriate for SBWGE and should be approved, subject to an annual reconciliation process that include a prudence review as described by Mr. Smith.

C. Gas Service

1. Introduction

Ms. Sonya Kessinger performed the cost of service studies for the SBWGE gas operations. Ms. Cheri L. Harden testified that Ms. Kessinger used COSS study allocators that are appropriate for designing gas rates and are the same allocators Staff would use in its COSS except for one specific allocator. (Staff Exhibit No. 5.0 at 3) Ms. Harden recommended that SBWGE utilize the average and peak ("A&P") allocator, and proposed new rates reflecting use of the A&P allocator. In response to Staff's suggestion, SBWGE proposed new rates using the A&P allocator.

SBWGE and Staff reached agreement on the revision to service lateral costs as shown in the tariff. SBWGE proposed increasing the charge for Plastic 1-inch or less service pipe from a $2.50 incremental charge per foot to $3.65; increasing the charge for Plastic 2-inch service pipe from a $3.65 incremental charge per foot to $6.25; and adding a Steel 2-inch service pipe with a charge of $9.80 per incremental foot. Staff reviewed SBWGE's proposal and supporting documentation supplied in response to DR CLH-8 and found the service lateral costs to be reasonable. (Staff Exhibit 11.0 at 2) The Commission finds that these proposals are supported by the record and should be approved.

In it's filing, SBWGE updated its Gas Tariff to correct typographic errors and reorganize the material in the tariffs. Staff had two areas of concern in the General Rules and Regulations proposed in Gas Tariff Volume No. 11 replacement. Staff proposed minor changes in tariff language in which SBWGE concurred. (Staff initial brief at 48-49) The Commission agrees that these proposals are reasonable and should be adopted.

Staff also recommended that the Commission approve the annual usage review as proposed by the Company. In Staff's view, the review process for each account will provide a beneficial service to customers and ensure customers are being served under the appropriate rate schedule. (Staff initial brief at 49, citing Staff Ex. 5.0 at 11) The Commission finds that the proposed annual usage review is appropriate and shall be utilized.

2. Gas Rate for Large Service Customers

The Company's three customer rate classes are Gg-1 Small Service, Gg-2 Large Service and Gg-7 Interruptible Service. While SBWGE and Staff agree with the general proposition that rates should be cost based, there remains one contested issue involving rates for the Gg-2 Large Service Customers.

a. Staff's Position

Staff recommended that the Gg-2 Large Service customer class rates should not change from the existing tariff. Under Staff's proposed revenue requirement, base rate increases would be approximately 11% and 21% for the Gg-1 and Interruptible rate classes, respectively. According to Staff, the Gg-2 class has been "over earning" by a substantial amount over the Gg-1 and Gg-7 customer classes. That is, it is Staff's position that rates for the Gg-2 class should not be increased since this class is already paying significantly more than the proposed rate of return. In Staff's view, this class is shouldering too much of the costs already and therefore, no increase is appropriate at this time. (Staff initial brief at 47, citing Staff Ex. 5.0 at 7)

Staff does not believe that rate shock is an issue when rates have not changed for 18 years. Staff claims that even if the approved rate increases are perceived as rate shock, Staff does not believe that rate shock would be alleviated for the Gg-1 and Gg-7 classes by the very slight increase for Gg-2 rate class customers of 2%. (Staff reply brief at 20)

b. SBWGE's Position

SBWGE recommends that the Gg-2 class be given a portion of the rate increase. SBWGE claims this is necessary so that the rate increase appears to be fair to all customers. SBWGE proposes an increase of 10% to this class, which is captured in the volumetric rate component. SBWGE contends that this increase is slight, resulting in only a two percent increase to the average monthly bill for this class including gas costs. (SBWGE initial brief at 44, citing SBWGE Ex. SMK-4, Schedule E-6, page 2 of 3) Under the Company's proposed revenue requirement in its rebuttal filling, base rate increases would be approximately 29% and 27% for the Gg-1 and Interruptible rate classes, respectively.

SBWGE believes that the move to cost-based rates should be done gradually and should address the perception of fair treatment. It is SBWGE's position that it is reasonable to allocate costs so that all classes are asked to shoulder some of the burden of a rate increase. The Company argues that by proposing a much smaller increase to the Gg-2 class, rates move closer to cost-based and this slightly mitigates the increase to the other classes. (SBWGE initial brief at 44-45)

SBWGE complains that Staff witness Harden did not address how her proposal would mitigate rate shock to the Gg-1 and Gg-7 customer, if the Gg-2 class did not bear any of the proposed rate increase. SBWGE also claims that Ms. Harden does not present any testimony that establishes SBWGE's proposed rate design is unreasonable. According to SBWGE, her only basis for the change is that she believes the Gg-2 class has been over earning by a substantial amount over the Gg-1 and Gg-7 customer classes. (SBWGE initial brief at 45)

c. Commission's Analysis and Conclusions

The Company wants to increase base rates for the Gg-2 rate class by 10% while Staff objects to any increase in rates for this class. The record shows that SBWGE's rebuttal position would produce base rate increases of approximately 29%, 10%, and 27% for the Gg-1, Gg-2 and interruptible rate classes, respectively, with an overall base rate increase of 27%. The Company believes a 10% increase for the Gg-2 class is appropriate so that the rate increase appears to be fair to all customers, and will result in only a two percent increase to the average monthly bill for the Gg-2 class when all gas costs (including PGA costs) are considered.

Staff's proposal would produce base rate increases of approximately 11%, 0% and 21% for the Gg-1, Gg-2 and interruptible rate classes, respectively, with an overall base rate increase of 15.95%. On a total revenue basis, including PGA revenues, the overall increase recommended by Staff is 4.38%. (Staff Ex. 11.0, Schedule 11.1) Staff opposes any increase in rates for the Gg-2 class because base rate revenues from that class are already well above cost of service.

The Commission observes that rate design by its nature is somewhat subjective and requires balancing competing objectives, such as setting rates at cost versus mitigating rate shock for certain customer classes. All other things being equal, the Commission has a preference that rates be set as close as possible to the cost of service for each class. On the other hand, mitigating rate impacts on other rate classes, as urged by the Company, also warrants consideration.

The problem with the Company's proposal in the instant case is the extent to which rate class Gg-2 is above cost of service. Expressed in terms of cost of service, if class revenues are set at cost, each class would generate the same overall rate of return. At present rates, rate class Gg-2 provides a 47.06% rate of return, while the other two rate classes provide rates of return below 3.00%. At SBWGE's proposed rates, the rate of return provided by rate class Gg-2 declines slightly, while the rates of return provided by the other classes increase somewhat toward the overall rate of return. (SBWGE Ex. SMK-3.1, WPE-2) Thus, while there would be some movement toward cost of service under the Company's proposal, rate class Gg-2 would still be too far in excess of cost of service to justify imposing any increase on that class. Therefore, the Commission finds that rates should not be increased for the Gg-2 rate class at this time.

As for the Gg-1 and Interruptible rate classes, under Staff's proposal the interruptible class would face an increase that is almost twice the percentage faced by the Gg-1 rate class. This result appears reasonable, in that the Gg-1 class is paying rates that approximate the cost of service while the Interruptible class is paying well below cost of service.

With respect to concerns about the need to mitigate rate shock to the Gg-1 and Interruptible classes, the Commission observes that the revenue requirement resulting from the Commission's conclusions in prior sections of this Order is lower than that proposed by the Company, and produces rate increases for the Gg-1 and Interruptible classes that are below the increases proposed by the Company for each of those classes. Thus, rate impacts on the Gg-1 and interruptible rate classes are mitigated without having to increase rates to the Gg-2 class.

In conclusion, the Commission believes that the class revenue increases proposed by Staff will produce base rates for each rate class that move toward cost of service, while avoiding unduly large increases on any class, and are just and reasonable.

3. Compliance Tariff Filing

Staff recommended that the Commission order the Company to file new Rate, Rules, Regulations and Conditions of Service tariffs within ten days of the Commission Order, with an effective date of not less than ten business days after the date of filing, for service rendered on and after their effective date, with individual tariff sheets to be corrected within that time period if necessary. (Staff initial brief at 53)

Staff witness Harden testified that in the event the Commission adopts a revenue requirement that differs from Staff's proposal, the difference should be applied to the rates that Staff has changed in this case on an equal percentage basis to recover the appropriate class revenue requirement. In this case, Staff proposed changes to the customer charge for rate Gg-1, Small Service customers and both the customer charge and the commodity charge for Gg-7 Small Interruptible customers. (Staff Ex. 5.0 at 9)

SBWGE states that if in the event that the Commission allows a higher revenue requirement than Staff proposed, SBWGE does not agree with the rate design proposed by Staff. SBWGE says that Staff proposes to split any Commission increase fifty-fifty between the two rate classes, Gg-1 and Gg-7. In SBWGE's view, Staff's proposal is arbitrary and is not based on cost or policy issues. SBWGE recommends that any such increase be proportionately allocated on SBWGE's current rate design giving each class the same proportion of any increase. (SBWGE initial brief at 45)

In its reply brief, Staff states that if the Commission follows SBWGE's recommendation for proportionally allocating a different revenue requirement, the Other Revenue charges should be removed from the Commission's approved total revenue requirement. Staff says the Commission should then determine the percentage difference between the Commission's approved revenue requirement and Staff's recommended revenue requirement. Staff suggests that percentage change should then be applied to each rate that Staff proposed changing. According to Staff, this method would change the rates on a weighted basis. (Staff reply brief at 20-21)

The Commission has reviewed the record on this issue, including Staff Ex. 5.0, Schedule 5.1 and Staff Ex. 1.0, Schedule 1.1. Although no adjustment in class revenues is in fact necessary because the revenue requirement proposed by Staff is approved in this Order, the Commission believes it would be appropriate to address the issue. Based on the record, the Commission finds that Staff's proposal to allocate any difference in revenue equally between the two classes should not be adopted. In the Commission's view, an allocation that does not consider the relative size of the classes, particularly where revenues from one class are approximately six times the revenues from the other class as is the case in this docket, would produce unduly large rate impacts on the smaller class. Also, the results do not appear to be consistent with Staff's overall proposal regarding interclass revenue allocations.

The Company's proposal, as the Commission understands it, would allocate any difference in revenue requirement among the two rate classes in proportion to the total revenues associated with each class. The Commission finds that the Company's recommendation is the more reasonable of the two. It avoids undue impacts on smaller rate classes and is more consistent with Staff's underlying class revenue allocation proposal in terms of interclass revenue and cost of service relationships. Finally, the Commission finds Staff's suggestion that "Other Revenue" be excluded from the allocation to be reasonable as that revenue does not appear to be derived from gas sales to the retail customer classes.

VIII. OTHER ISSUES

A. Original Cost Determinations

It is Staff's position that the Commission should make an original cost determination in this proceeding. Staff requests that the Commission include the following provision in the order:

> It is further ordered that the original cost of gas plant at December 31, 2002, as reflected on Company Ex. MWS-1 Gas, Schedule B-2, line 10, column (G) of $11,192,009 is unconditionally approved as the original cost of gas plant for consideration of 83 Ill. Adm. Code 510.
>
> It is further ordered that the original cost of water plant at December 31, 2002, as reflected on Company Ex. MWS-1 Water, Schedule B-2, line 15, column (G) of $6,088,177 is unconditionally approved as the original cost of water plant for consideration of 83 Ill. Adm. Code 615.
>
> (Staff initial brief at 53-54, citing Staff Ex. 1.0 at 3)

The Commission notes that the Company does not object to Staff's proposal. The Commission finds this recommendation to be reasonable.

B. Gas Contract Between WPL and SBWGE

1. Staff's Position

In Docket No. 97-0088, the Commission entered an Order on June 11, 1997 authorizing the Company to modify its contract for gas services with its parent company, WPL. The agreement being modified in that docket was executed in the early 1980's. According to the Order in 97-0088, the contract before the Commission in that docket specifies how costs of natural gas supply and other expenses shall be allocated between the respective utilities.

In the instant proceeding, Staff recommends that the Commission order the Company to file a petition requesting approval of a new gas contract between SBWGE and WPL within six months of the order date in this proceeding.

According to Staff, this issue turns on whether the current gas contract does, in fact, provide for direct costs and rate base to remain on the books of SBWGE, with only an incremental allocation of indirect costs and rate base from WPL, or whether the current gas contract effectively replaces the direct costs incurred by SBWGE with a percentage allocation of WPL's total costs. (Staff initial brief at 54) Staff argues that the methodology utilized in the current gas contract effectively replaces all direct costs incurred by SBWGE with a percentage allocation of WPL's total costs. (Staff initial brief at 54, reply brief at 22)

Staff explains that the current gas contract uses an allocation methodology wherein gas operations and rate base are derived by allocating a percentage of WPL's total gas costs and rate base to SBWGE, based on sales of gas by SBWGE proportionate to combined gas sales of SBWGE and WPL, or based on the number of SBWGE customers proportionate to combined customers for SBWGE and WPL. (Staff initial brief at 55, citing Staff Cross Ex. 2 - Seitz)

Staff states that the Commission approved a new water services contract between SBWGE and WPL (Docket No. 03-0462, Order entered March 17, 2004), which changes the method by which SBWGE is allocated costs for the water services it receives from WPL. Staff claims the new methodology reflects all direct costs incurred by SBWGE plus an allocation for certain incremental indirect costs from WPL. (Staff initial brief at 55)

In contrast, Staff asserts, the methodology utilized in the current gas contract effectively replaces all direct costs incurred by SBWGE with a percentage allocation of WPL's total costs. Staff claims this is apparent from a review of Formulas 2 through 5 of the existing gas contract. (Staff Cross Ex. 2 – Seitz) Staff says it is also evident from the allocation of rate base to SBWGE, as detailed on Schedules B-1 and B-6 attached to the direct testimony of Company witness Martin W. Seitz. (Staff initial brief at 55 and reply brief at 22-23, citing SBWGE Ex. MWS-1, Schedules B-1 and B-6)

Staff agrees with the Company's assertion that the direct costs incurred by SBWGE remain on its books, however, Staff argues that the effect of the allocation methodology used by the Company is that regardless of the amount of the direct costs on SBWGE's books, the final amounts on SBWGE's books will reflect the allocation of the combined SBWGE and WPL costs, thereby effectively replacing the direct costs with an allocation. (Staff initial brief at 56, reply brief at 24)

Staff says its primary concern is that the rates charged to SBWGE customers should reflect, to the extent possible, the actual costs incurred to provide service. According to Staff, assigning costs directly to SBWGE, with allocations only for indirect/un-assignable costs that are necessary to provide gas service to SBWGE customers, would accomplish this objective. (Staff initial brief at 57)

Staff recommends that the Commission order the Company to file a petition requesting Commission approval of a new gas contract between SBWGE and WPL within six months of the order date in this proceeding. In Staff's view, the new gas contract should allow direct costs and rate base components that are directly assignable to SBWGE to remain in its financial records. Staff argues that allocations from WPL should only represent SBWGE's share of such incremental items as common and general rate base, and certain costs that are not directly assignable to a specific entity at the time they are incurred, like the methodology used in the new water services contract approved in Docket No. 03-0462. (Staff initial brief at 57)

Staff witness Pierce testified that the Company's new Enterprise Resource Planning ("ERP") System allows SBWGE to track the direct costs incurred by SBWGE to a much greater extent, and suggest that this information should be reflected in the accounting resources of SBWGE. She asserts that the Company will now have the resources to capture more of the direct costs related to SBWGE's gas operations and would benefit by reflecting this actual cost data in its financial reports to the extent possible. (Staff Ex. 1.0 at 11-12)

2. SBWGE's Position; Staff Response

According to SBWGE, Staff is proposing to eliminate the current gas contract and its approved allocations, which would replace the current methodology despite the fact Staff has presented no evidence that the current gas contract methodology is unreasonable. SBWGE also argues that Staff does not apply the facts surrounding the current situation and unique operations of SBWGE. The Company says that Staff tries to compare the gas contract with the new water services contract, yet does not factor in the changes surrounding the changes in SBWGE's water facilities since the sale of the WPL water facilities to the City of Beloit. SBWGE states that the existing gas contract covers an integrated gas distribution system comprising the Beloit, Wisconsin area and the SBWGE service area. The Company asserts that by contrast, the water services contract does not cover an integrated system where the parent company is supplying the source of the service. (SBWGE initial brief at 7-8)

In SBWGE's view, the circumstances that gave rise to the need to seek approval of a new water contract do not exist for the gas utility. The Company claims that the old water contract needed revisions because part of the resources previously provided by WPL to SBWGE could no longer be provided by WPL after WPL sold its water utility facilities to the City of Beloit, Wisconsin. SBWGE contends that this is not the case with the gas utility. The Company states that WPL still owns the gas facilities in the Beloit, Wisconsin area and together with the gas facilities in the SBWGE area, the facilities represent an integrated system that is operated to the benefit of the customers served. (SBWGE initial brief at 8-9)

SBWGE argues that the gas utility assets in Illinois are owned by SBWGE and have not been replaced by an allocation, and that the costs are directly assigned to SBWGE. (SBWGE initial brief at 9)

SBWGE says it depends on its parent, WPL, for many services it cannot provide. The Company claims it is reasonable to look at the facilities and the costs that are being provided and allocate those incremental costs in a manner consistent with the manner in which those assets are being utilized. SBWGE asserts that under the current gas contract it first assigns direct costs to SBWGE and then allocates only incremental costs on assets owned by WPL and located in Wisconsin, all in accordance with the approved formulas in the gas contract. SBWGE believes this method is reasonable and asserts that the reasonableness of the gas contract was the basis for Commission approval in 1997. In SBWGE's view, circumstances have not changed since 1997 that would require a change in the gas contract. (SBWGE initial brief at 9, reply brief at 2)

According to SBWGE, Staff does not give any statutory basis on which the Commission can rely on in order to direct SBWGE to file a petition for Commission approval of a new gas contract. SBWGE contends that the Commission should reject Staff's proposal because Staff's proposal goes beyond the scope of the Act and Staff does not establish the current gas contract is unreasonable. According to SBWGE, there is no legal basis in the Act that permits the Commission to unilaterally compel a utility to enter into negotiations and consummate a contract with a third party. The Company contends that unless SBWGE's business conditions prompt it to enter into a new contract and arrangement with WPL for gas services and SBWGE seeks Commission approval of the new the arrangement, the gas contract must continue to apply. (SBWGE initial brief at 10, reply brief at 2-3)

In response to the Company, Staff says it has not contended that the current gas contract is unreasonable, nor does Staff believe it needs to demonstrate that the current contract is unreasonable in order to recommend that it could be improved. Staff argues that the current gas contract should be changed so that rates reflect, to the extent possible, the actual costs incurred to provide service. Staff says this is its primary concern, and whether the gas or water systems are fully integrated or not is irrelevant to this goal. (Staff reply brief at 22)

In reply to SBWGE's complaint that Staff offered no specific changes to the gas contract to make an amended contract superior to the existing gas contract, Staff says it provided numerous illustrations of the types of changes that would improve the existing gas contract. Staff argues that a detailed review of the existing gas contract, including specific changes that the Company refers to in its initial brief, is beyond the scope of Staff's recommendation within this rate proceeding. Staff believes a detailed review of the existing contract is properly conducted within a separate docket. (Staff reply brief at 24)

In response to the Company's argument that Staff's proposal goes beyond the scope of the Act and Staff does not establish the current gas contract is unreasonable, Staff cites Section 7-101(3) of the Act. Staff argues that although the Commission approved the existing gas contract in Docket No. 97-0088, nothing in the Act precludes the Commission from requesting the Company to submit an updated contract for its review. (Staff reply brief at 25)

3. Commission's Analysis and Conclusions

In Docket No. 97-0088, the Commission entered an Order on June 11, 1997 authorizing the Company to modify its contract for gas services with its parent company, WPL. According to the Order in 97-0088, the contract before the Commission in that docket specifies how costs of natural gas supply and other expenses shall be allocated between the respective utilities.

Staff asserts that the methodology utilized in the current gas contract effectively replaces all direct costs incurred by SBWGE with a percentage allocation of WPL's total costs. Staff's primary concern is that the rates charged to SBWGE customers should reflect, to the extent possible, the actual costs incurred to provide service. Staff recommends that the Commission direct the Company to file a petition requesting approval of a new gas contract between SBWGE and WPL, within six months of the order date in this proceeding, that reflects more direct assignments of costs, and thus less allocations of costs, to the Company. The Company opposes Staff's recommendation.

SBWGE complains that Staff does not cite any statutory basis under which the Commission can direct SBWGE to file a petition for approval of a new gas contract and that Staff's proposal goes beyond the scope of the Act. The Company contends that unless SBWGE's business conditions prompt it to enter into a new contract and arrangement with WPL for gas services and SBWGE seeks Commission approval of the new arrangement, the gas contract must continue to apply.

In the Commission's view, if the Company is contending that the Commission lacks the authority to review the terms of the affiliated interest contract in question unless the Company consents to such a review or decides on its own to file a new contract, such an argument is incorrect. Were this a gas contract between SBWGE and an unaffiliated third party, SBWGE's arguments might have some merit. However, this contract involves an affiliate of SBWGE and the Commission has jurisdiction over the contract as indicated in Docket 97-0088.

The Commission is empowered under Article VII of the Act with jurisdiction over transactions between utilities and their affiliates to protect the interests of customers of regulated utilities. Such transactions require scrutiny to ensure they are not structured in a manner that improperly bestows benefits on the utility affiliate at the expense of the regulated utility and its customers. Thus, the Act subjects such transactions to Commission oversight. This oversight is particularly important because many of those contracts, including the one in question here, allocate or assign costs that the Company eventually seeks to recover from customers through the ratemaking process.

In addition to the Commission's general and ongoing oversight of utilities and specific oversight of transactions between a utility and its affiliates, Section 10-113 of the Act authorizes the Commission to rescind, alter or amend any rule, regulation, order or decision made by it. The Commission in Docket 97-0088 on June 11, 1997 approved the gas contract between SBWGE and WPL. The Commission has authority to revisit that gas contract under the Act as long as reasonable notice and opportunity to be heard are provided. Here, the Company has had ample opportunity to address whether the matter should be revisited. The Company will have an additional opportunity to address the appropriateness of the terms of the contract in a further proceeding, and the agreement in question will remain in effect unless modified or superseded by further order of the Commission following notice and opportunity to be heard.

Turning next to policy considerations, Staff argues that the Commission should revisit the gas contract issue because under the gas contract, too many costs are allocated rather than directly assigned to SBWGE. Among other things, SBWGE complains that Staff has failed to demonstrate that the existing contract is unreasonable. The Company suggests that the contract properly assigns direct costs and properly allocates other non-direct costs.

The Commission has reviewed the record and believes it is appropriate to reexamine the gas contract between WPL and SBWGE. While it is not entirely clear to the Commission which gas services costs were directly assigned and which were allocated in this proceeding, it is clear that the contract approved in Docket 97-0088 results in many costs under the contract, including those included in rate base and other elements of revenue requirement, being allocated, rather than directly assigned, to SBWGE.

While SBWGE argues that circumstances have not changed since the existing gas contract was approved, it does not directly dispute Staff's assertion that it is now possible for the Company to engage in additional or improved direct assignment of costs. Staff contends that the possibility of additional or improved direct assignment is evidenced by SBWGE's recently adopted water supply contract. As stated elsewhere in this order, the Commission believes it is important for customers' rates to reflect the actual cost of providing service to the extent possible. If costs are not properly assigned or allocated, the Commission's ability to establish cost based rates is impaired. As indicated by Staff, costs that are directly assigned, whenever reasonably possible, will more accurately reflect the actual costs of providing service than will costs that are allocated.

To facilitate the review of gas services costs in the next rate case and ensure rates reasonably reflect the cost of service, the Commission hereby directs SBWGE to file a petition within six months after the final order is entered in this proceeding. That petition shall seek approval of a gas services contract with WPL. The six-month period is intended to provide the Company sufficient time to review the gas services contract and incorporate any proposed revisions it deems appropriate.

With respect to the specific approvals to be sought in the petition to be filed in six months, the Commission does agree with SBWGE in one respect. The Company should not be required to seek approval, in the prayer for relief in the petition, of a contract with WPL that contains terms with which the Company disagrees. Hence, in the contract for which it seeks approval, the Company may propose whatever gas services cost assignment and allocation methodologies it believes are reasonable; however, in connection with that petition, the Company is directed to explain why it believes its proposed cost assignment and allocation methodologies being proposed are appropriate. In that proceeding, Staff and other parties will have the opportunity to review the Company's filing and propose such modifications or conditions as they deem appropriate.

Finally, the Commission reiterates that in the instant rate proceeding, it is not denying SBWGE the opportunity to recover any costs incurred under the existing gas contract, and the existing gas supply contract will remain in place unless modified or superseded by further order of the Commission after concluding its reexamination.

IX. FINDING AND ORDERING PARAGRAPHS

The Commission, having reviewed the entire record herein, is of the opinion and finds that:

(1) South Beloit Water Gas and Electric Company is in the business of furnishing water, gas and electric service to the public in various areas in the State of Illinois and is a public utility as defined in the Public Utilities Act;

(2) the Commission has jurisdiction of the parties and of the subject matter herein;

(3) the findings and conclusions contained in the prefatory portion of this Order are supported by the evidence of record and are hereby adopted as findings of fact; Appendices A and B attached hereto provide supporting calculations for various conclusions in this Order;

(4) the test year in this proceeding is a historic test year consisting of the 12 months ending December 31, 2002, as adjusted; such test year is appropriate for purposes of this proceeding;

(5) for purposes of this proceeding, SBWGE's net original cost rate base for gas service is $6,290,594 and for water service is $3,998,653, as set forth in Appendices A and B, respectively;

(6) a just and reasonable rate of return which SBWGE should be allowed an opportunity to earn on its net original cost gas rate base is 8.41%; this rate of return incorporates a rate of return on common equity of 9.87%;

(7) a just and reasonable rate of return which SBWGE should be allowed an opportunity to earn on its net original cost water rate base is 8.29%; this rate of return incorporates a rate of return on common equity of 9.64%;

(8) the rates of return set forth in Findings (6) and (7) hereinabove result in operating revenues and net annual operating incomes as shown in Appendices A and B, based on the test year herein approved;

(9) SBWGE's rates which are presently in effect for water service and gas service are insufficient to generate the operating income necessary to permit SBWGE the opportunity to earn a fair and reasonable return on net original cost rate base; these rates should be permanently canceled and annulled;

(10) the rates proposed by SBWGE will produce a rate of return in excess of a return that is fair and reasonable; SBWGE's Proposed Tariffs should be permanently canceled and annulled;

(11) SBWGE should be authorized to place into effect tariff sheets designed to produce annual operating revenues as contained in Appendices A and B, such tariff sheets to be applicable to service furnished on and after their effective date; the terms and conditions in these tariff sheets shall be consistent with Findings (12) and (13) below;

(12) the cost of service, interclass revenue allocation, rate design, and tariff terms and conditions found appropriate in the prefatory portion of this Order are just and reasonable for purposes of this proceeding and should be adopted;

(13) the new tariff sheets authorized to be filed by this Order shall reflect an effective date not less than ten working days after the date of filing, with the tariff sheets to be corrected within that time period if necessary.

IT IS THEREFORE ORDERED that the Proposed Tariffs proposing a general increase in rates, filed by South Beloit Water Gas and Electric Company on October 10 and October 15, 2003, are permanently cancelled and annulled.

IT IS FURTHER ORDERED that South Beloit Water Gas and Electric Company is authorized and directed to file new tariff sheets with supporting workpapers in accordance with Findings (11), (12) and (13) of, and other determinations in this Order, applicable to service furnished on and after the effective date of said tariff sheets.

IT IS FURTHER ORDERED that upon the effective date of the new tariff sheets to be filed pursuant to this Order, the tariff sheets presently in effect for gas service and water service rendered by South Beloit Water Gas and Electric Company which are replaced thereby are hereby permanently canceled and annulled.

IT IS FURTHER ORDERED that within six months of the date of this Order, SBWGE shall make the filing described under "Gas Contract Between WPL and SBWGE" in Section VIII of this order above.

IT IS FURTHER ORDERED that the original cost of gas plant at December 31, 2002, as reflected on SBWGE Ex. MWS-1 Gas, Schedule B-2, line 10, column (G) of $11,192,009 is approved as the original cost of gas plant pursuant to 83 Ill. Adm. Code 510.

IT IS FURTHER ORDERED that the original cost of water plant at December 31, 2002, as reflected on SBWGE Ex. MWS-1 Water, Schedule B-2, line 15, column (G) of $6,088,177 is approved as the original cost of water plant pursuant to 83 Ill. Adm. Code 615.

IT IS FURTHER ORDERED that all objections or motions in this proceeding that have not been ruled upon are hereby deemed disposed of in a manner consistent with the ultimate conclusions herein contained.

IT IS FURTHER ORDERED that subject to the provisions of Section 10-113 of the Public Utilities Act and 83 Ill. Adm. Code Section 200.880, this Order is final; it is not subject to the Administrative Review Law.

By proposed order this 25th day of August, 2004.

Administrative Law Judge